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TAX EXPENDITURES IN MONTANA:

CONCEPT, REPORTING, AND REVIEW

A Report to the Governor and the 54th Legislature

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CONCEPT, REPORTING, AND REVIEW

A Report to the Governor and the 54th Legislature

From the

REVENUE OVERSIGHT COMMITTEE

As Required by
House Joint Resolution No. 30
53rd Legislature

Prepared by
Jeff Martin, Staff Researcher

November 1994

Published by
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INTRODUCTION

HOUSE JOINT RESOLUTION NO. 30 -- TAX EXPENDITURE STUDY

House Joint Resolution No. 30, passed by the 53rd Legislature, requested that the Revenue Oversight Committee (Committee) study tax expenditures as they relate to the state's budgeting process. In its study, the Committee was directed to:

- evaluate the purpose and effectiveness of all tax expenditures in the Department of Revenue's Tax Expenditure Report for the State of Montana: Fiscal Years 1994 and 1995;
- evaluate the tax expenditure report and make recommendations for changes in reporting procedures or on tax expenditures that may not be included in the report;
- compare Montana's tax expenditures to those of other states, particularly neighboring states; and
- develop options for consideration and recommendations, including legislation, if considered appropriate, for changes in existing statutes on tax expenditures.

House Joint Resolution No. 30 also directed the Committee to solicit the knowledge and advice of tax policy experts, local government officials and representatives, taxpayer groups, the Montana Department of Revenue (Department), and any other entity that may have relevant information or insights.

BACKGROUND

Tax expenditures are the use of public resources for public purposes and are allocated in the same manner as appropriations are, but the allocations are accomplished through the tax system rather than by direct expenditures.* The purpose of tax expenditures is to encourage certain taxpayer behavior, to provide incentives for economic activity, or to provide financial relief for certain

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* Karen M. Benker, "Tax Expenditure Reporting: Closing the Loophole in State Budget Oversight", National Tax Journal, Vol. XXXIX, No. 4, December 1986, p. 404.

taxpayers. The use of tax expenditures results in foregone revenue through special tax exemptions, deductions, exclusions, credits, deferrals, or other preferential treatment in the tax code.

In Montana, tax expenditures represent a significant amount of foregone revenue. They also generally operate as off-budget entitlement programs that are not limited to a set dollar amount. Tax expenditures do not necessarily represent good or bad policy. Many tax expenditures are generally believed to serve legitimate goals, while others are considered tax giveaways. However, unlike on-budget entitlement programs, tax expenditures do not generally undergo any kind of systematic review. There is no procedure to approve or disapprove the continuation of tax expenditures.

The concept of tax expenditures was developed at the federal level in the late 1960s by Stanley S. Surrey, Assistant Secretary for Tax Policy of the U.S. Treasury Department. The first federal tax expenditure "budget" was produced for a 1967 treasury report. Since that report, many states, including Montana, have adopted some form of tax expenditure reporting.

STUDY CONTENTS

This final report is the culmination of a series of reports presented to the Committee. The contents of those reports have been combined and reorganized in an effort to present a logical and consistent discussion of tax expenditure reporting.

The report is divided into four chapters. Chapter One examines the tax expenditure concept in general. It briefly describes the rationale for the development of tax expenditures at the federal level and discusses how federal tax expenditures are determined. Chapter Two presents a descriptive analysis of tax expenditure reporting in Montana. Chapter Three summarizes the significant features of selected states' tax expenditure reports. Despite the seeming popularity of tax expenditure reports, most states that prepare these reports display a reluctance to engage in the systematic review of tax

expenditures in the manner that was intended. Chapter Three presents some reasons for that reluctance. Chapter Four revisits Montana tax expenditures and highlights some of the tax and budgetary impacts of tax expenditures in the state.

Although the Committee listened patiently to the reports, it showed little interest in formally (or informally, for that matter) expanding the scope and review of tax expenditures in Montana. The final report does include a number of suggestions and recommendations for the improvement of the state's tax expenditure report. Appendix A is the Department's response to some of those suggestions and recommendations.

CHAPTER ONE

THE TAX EXPENDITURE CONCEPT

INTRODUCTION

A tax system is defined in terms of a base (e.g., income, sales, consumption, or wealth), a set of tax rates, and accounting rules. The tax system generally incorporates a variety of exemptions, deductions, or other special provisions that deviate from the basic rules of the tax system. These deviations from the basic rules are generally referred to as tax expenditures. Tax expenditures are found in all federal, state, and local tax systems, including but not limited to income, sales, and property taxes.

The purpose of tax expenditures is to encourage certain taxpayer behavior (e.g., charitable contributions), to provide economic incentives for economic activity (e.g., investment tax credits), or to provide financial relief for certain taxpayers (e.g., elderly homeowners' or renters' credit). When a tax system is adjusted to reduce or eliminate the tax payments of taxpayers who engage in a favored activity or who are in a favored group, the effect (on both the taxpayer and the public treasury) is analogous to a direct expenditure for public purposes.[1]

The use of tax expenditures to subsidize a desired activity or to provide financial relief has some advantages over direct expenditures. First, tax expenditures are decentralized. For example, under the individual income tax, a taxpayer who engages in the desired activity simply claims the benefit on the tax return. Second, tax expenditures are relatively easy to administer and involve little intrusion from government (except for the occasional nasty audit of a tax return). Third, authorization of tax expenditures is simple--they require no appropriation.

There are also disadvantages to using tax expenditures to achieve public policy objectives. First, there is little information about who receives the benefit of the tax expenditure. Most taxpayers take advantage of the tax breaks available to them, but they may think that others with smarter accountants and more

income to shelter may somehow take undue advantage of the system. This suspicion may cause taxpayers to regard the tax structure as unfair. Second, tax expenditures receive little review because the tax code is not reauthorized every budget cycle. As a result, tax expenditures become entitlement programs and, as is the case with direct expenditure entitlements, are hard to control. Third, there is little coordination between the appropriation committees that consider direct expenditures and the tax committees that consider tax expenditures. This lack of coordination limits the control of the use of public resources allocated through the tax system.

FEDERAL TAX EXPENDITURE REPORTING

Tax expenditures have been part of the federal income tax system since its inception. Deductions for mortgage interest and for state and local property taxes have been in effect since 1913; the deduction for charitable contributions has been in effect since 1917.[2]

In the 1960s, tax reformers began urging a formal scrutiny of tax expenditures at the federal level. The first tax expenditure budget was produced for a 1967 treasury report by Stanley S. Surrey, Assistant Secretary for Tax Policy of the U.S. Treasury Department. Surrey contended that tax systems consist of two parts. The first part defines the tax base, the tax rates, and the accounting rules. These elements define the "normal" tax system. The normal tax system establishes the framework to administer the tax in an efficient manner without imposing undue hardship on taxpayers. The second part consists of exemptions, deductions, and other special provisions related to specifically identified portions of the tax code.[3]

Tax expenditure reporting was formally incorporated into the federal budget process under the Congressional Budget and Impoundment Control Act of 1974. The Act required the Office of Management and Budget (OMB) to include a tax expenditure analysis with the President's annual budget. The Congressional Budget Office (CBO), in conjunction with the Joint Committee on Taxation (JCT), is also required to produce a tax expenditure budget.

The determination of the normal tax structure, the identification of tax expenditures, and the estimation of foregone revenue associated with tax expenditures are difficult tasks, both technically and politically. For several years, the OMB and the congressional agencies (the JCT and the CBO) generally agreed on the "normal" tax structure and on the deviations from it. Tax expenditure budgets were prepared using a general (and essentially theoretical) definition of a comprehensive income tax base, known as the Haig-Simons income tax base.* In 1983, however, the OMB adopted a more restrictive interpretation of the general tax base and the deviations from it. The OMB instituted a "reference law" guideline in place of the normal tax guideline.[4] The OMB maintained that the reference tax base should reflect the general rules in the tax code and that tax expenditures would be identified by special exceptions to the general provisions. As a result of this new interpretation, some items that had been considered tax expenditures under the normal tax structure were really general provisions of the tax code.

The most controversial aspect of the OMB's heresy involved the treatment of accelerated depreciation of business property. Under the Haig-Simons concept, depreciation in excess of the so-called economic life of an asset (e.g., straight-line depreciation) is treated as a tax expenditure. Under the OMB's new interpretation, accelerated depreciation is as good a definition for depreciation as any other--it is, therefore, a general provision of law and is not a tax expenditure.[5]

The OMB also developed an alternative method for reporting tax expenditures ("Special Analysis G", submitted with the executive budget). In addition to determining foregone revenue associated with tax expenditures, the OMB also compiled figures showing program outlay equivalents. The reasoning was that if tax expenditures are equivalent to direct expenditures, they should be reported in a manner comparable to that of the outlay budget.[6] Revenue losses would have to be "grossed up" to an equivalent taxable cash payment. The grossed-up figure is the amount of direct payment that a recipient of

---

* Income is equal to consumption plus changes in wealth between two points in time.

government largesse would have to receive to be as well off as with a tax deduction for the same purpose. For example, a taxpayer with a marginal tax rate of 30% who deducts $3,000 for home mortgage interest (a $900 tax benefit) would have to receive a cash payment of $1,285 (assuming the payment is taxable) to be as well off as with the tax deduction.

The outlay-equivalent approach provides a better analytical framework to compare the cost of tax subsidies with outlay budgets.[7] This approach shows the level of direct expenditures that would be required to alternatively fund an existing tax subsidy. It also eliminates the problem of trying to account for changes in taxpayer behavior as a result of the elimination of a tax subsidy (just one of the problems associated with estimating tax expenditures).

The OMB's reference rules and the outlay-equivalent approaches have not been adopted by the JCT and the CBO. The OMB, however, prepares one tax expenditure budget using the consensus guidelines and one budget using its revised guidelines.

The difference between measuring tax expenditures as revenue losses or as outlay equivalents has important policy implications, at least at the national level. The outlay-equivalent approach is more consistent with the notion that tax expenditures are expenditures. Using the outlay-equivalent method assists a legislative body in comparing tax subsidies with direct expenditures as an alternative means of achieving the same public policy goal.[8] On the other hand, the revenue-loss approach would provide better information if the purpose of the information is to revise the tax code to "enhance" revenue or to eliminate tax subsidies that have outlived their ostensible usefulness.

Whether the revenue-loss approach or the outlay-equivalent approach is the preferred method of reporting tax expenditures, there are important technical difficulties in deriving the estimates. For example, many activities are subsidized through tax exemptions. Because information on the amount of exemption is not always reported on the tax return (e.g., exempt interest on

state and local bonds), these types of tax expenditures must be estimated indirectly.

In addition, each tax expenditure estimate is determined in isolation from other tax expenditures. If two or more tax expenditures were repealed simultaneously, the total change in tax liability could be greater or smaller than the sum of the amounts determined for each item separately. For example, under a progressive rate structure, the elimination of several itemized deductions may cause more taxpayers to use the standard deduction than if itemized deductions were eliminated in isolation. As a result, taxpayers may be pushed into higher tax brackets because of an increase in taxable income. The revenue impact is further complicated because itemized deductions overlap the standard deduction. On the other hand, the elimination of one or more tax expenditures may cause taxpayers to engage in other tax-exempt activity.

STATE TAX EXPENDITURE REPORTING

The interest in tax expenditure reporting at the state level has grown considerably since the first federal tax expenditure report was issued in 1967. California was the first state to enact legislation (in 1971) to require tax expenditure reporting. California produced the first state tax expenditure report in 1976. Wisconsin adopted tax expenditure legislation in 1973, followed by Maryland and North Carolina in 1975.[9] By 1986, 17 states had adopted some form of tax expenditure reporting. Montana adopted tax expenditure reporting in 1987. The Corporation for Enterprise Development lists 27 states that now produce tax expenditure reports.[10]

Federal tax expenditure reports only provide tax expenditure estimates for individual income taxes and corporation net income taxes. State tax expenditure reports, on the other hand, may include estimates for individual and corporation income taxes as well as estimates for sales taxes, excise taxes, estate taxes, property taxes, and other taxes. Chapter Three describes tax expenditure reporting for selected states.

In 1987, the Montana Legislature passed House Bill No. 387 (Ch. 500, L. 1987), requesting the Department to compile information on foregone tax revenue attributable to individual income tax and corporation license tax exemptions, property tax exemptions, deferrals of income, tax credits, deductions, and any other identifiable preferential tax treatment. The Legislature also requested that the Department determine the "passive" amount of tax expenditures associated with federal income tax laws and to determine, when possible, the distribution of tax expenditures by taxpayer age and income. The next chapter summarizes the significant features of the Department's tax expenditure report.

ENDNOTES

1. Herman B. Leonard, Checks Unbalanced: The Quiet Side of Public Spending (New York: Basic Books, Inc., 1986), p. 107.

2. Ibid., p. 111.

3. Stanley Surrey and Paul McDaniel, Tax Expenditures (Cambridge: Harvard University Press, 1985), p. 3.

4. Kevin F. Murrey, Issues in State Tax Expenditure Reporting (New York: New York State Department of Taxation and Finance, February 1988), p. 11.

5. Leonard, Checks Unbalanced, p. 120.

6. Ibid., p. 120.

7. Ibid., p. 122.

8. Ibid., p. 123.

9. Karen M. Benker, "Tax Expenditure Reporting: Closing the Loophole in State Budget Oversight", National Tax Journal, Vol. XXXIX, No. 4, December 1986, p. 407.

10. The Corporation for Enterprise Development, The 1993 Development Report Card for the States (Washington, D.C.: The Corporation for Enterprise Development, 1993), p. 184.

CHAPTER TWO

TAX EXPENDITURE REPORTING IN MONTANA

INTRODUCTION

The Department published the first tax expenditure report in January 1989. That report provided estimates of tax expenditures for the 1990-91 biennium for individual income taxes, corporation license taxes, natural resource taxes, and property taxes. The report also included the legal citation for each tax expenditure and a brief description of the tax expenditure and its purpose. The Department has since published a tax expenditure report for the 1992-93 biennium and a tax expenditure report for the 1994-95 biennium.

This chapter summarizes the Department's tax expenditure estimates contained in each of the tax expenditure reports. Summary information is presented for tax expenditures associated with the individual income tax, the corporation license tax, natural resource taxes, and property taxes. The purpose of this summary is to provide a perspective on the kind of information presented in the tax expenditure reports and to give some sense of the historical trends in tax expenditure estimates and of the relative magnitude associated with each tax expenditure.

It must be kept in mind that the estimates are prospective in nature. That is, they represent the estimated amount of tax relief under current law for the ensuing biennium. Revised estimates of tax expenditures associated with legislative changes to the tax code are not calculated. The impact to any existing tax expenditure (or new tax expenditure) as the result of a legislative enactment would be reflected in the estimates for the next biennium.

This report is primarily concerned with summarizing existing information. It generally does not provide a detailed discussion of legislation affecting tax expenditures unless the legislation has a significant impact on the tax expenditure estimates. For example, Senate Bill No. 226 (Ch. 823, L. 1991) revised the taxation of retirement income and House Bill No. 671 (Ch. 634, L.

1993) generally revised the individual income tax. For the appropriate years, the report relates the impact of these two pieces of legislation on the tax expenditure estimates.*

MONTANA TAX EXPENDITURE ESTIMATES

Since 1989, the Department has provided the Montana Legislature in regular session with estimates of tax expenditures for the ensuing biennium. The estimates indicate the amount by which a tax expenditure reduces taxpayers' liabilities and represent the difference between tax liability under the existing tax structure and tax liability when the particular tax provision is assumed not to exist. This section describes the trends in estimated tax expenditures identified by the Department for each category of tax expenditure for fiscal years 1990 through 1995.

Tax Expenditures Under the Individual Income Tax

There are several components of tax expenditures under the Montana individual income tax. These include exclusions and deductions from federal income, Montana-specific exclusions and exemptions from income, Montana credits, and Montana itemized deductions.

This section presents several tables showing the Department's estimates for tax expenditure items allowed under the individual income tax as it existed at the time that the estimates were developed. Changes in the level of tax expenditures as the result of legislative action would not be accounted for until the next tax expenditure report. Each table shows tax expenditures by major category in descending order of magnitude and the aggregate amount for each category.

The reader should keep in mind that tax expenditures represent foregone revenue associated with each tax provision. Each tax expenditure estimate is

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* House Bill No. 671 has been suspended by an initiative petition. Montana voters will approve or reject House Bill No. 671 (as Initiative Referendum No. 112) on November 8, 1994. If the measure is rejected by the voters, the discussion of House Bill No. 671 in this chapter does not apply.

determined in isolation from other tax expenditures and from other provisions of the tax code. If two or more tax expenditures were estimated simultaneously, the total change in tax liability could be larger or smaller than the sum of the amounts determined for each item separately.[1] For example, under a progressive tax structure, the elimination of several itemized deductions would cause more taxpayers to use the standard deduction than if itemized deductions were eliminated in isolation. As a result, taxpayers may be pushed into higher tax brackets because of an increase in taxable income.* In addition, tax expenditure estimates do not take into account changes in taxpayer behavior in response to the elimination of a deduction. For example, the elimination of a particular deduction may cause taxpayers to increase tax deductions in other areas.

With those caveats in mind, the purpose of including totals is to allow the reader to appreciate the relative magnitude of tax expenditure items within a particular category and when compared to the total level of all tax expenditures.

Federal Exclusions From Income: Since 1955, Montana has used the definition of federal adjusted gross income as the starting point for determining Montana taxable income. As a result, most exclusions and deductions from federal income are incorporated in Montana's tax base. These items are referred to as "passive" tax expenditures. That is, tax expenditures allowed under the federal system are automatically incorporated into the state tax system. Because most federal exclusions and deductions are not specifically accounted for on the state tax return, those states that are tied to the federal system and that produce tax expenditure reports generally rely on national tax expenditure estimates developed by the OMB or the JCT to prorate or adjust those estimates to the state level. The Department uses JCT data to develop tax expenditure estimates under the Montana individual income tax and the

---

* The Montana income tax system provides a progressive rate structure and allows itemizad deductions. House Bill No. 671 would eliminate all itemized deductions and impose a flat rate on taxable income.

corporation license tax.* The Department has noted in each of its tax expenditure reports:

> Although this method is used by most states for deriving at least some of their tax expenditure estimates, it is also recognized as being a relatively crude estimating technique. For the individual income tax, it assumes that Montana's demographic characteristics (e.g., age and income distributions) and mix of industries are the same as those of the nation, and that Montanans' consumption and expenditure patterns parallel those nationally. Obviously, that is an oversimplification.[2]

The Department has made some adjustments to the national estimates to account for the fact that mining and agriculture are relatively more important in Montana than in the nation as a whole. Nevertheless, the estimates for federal exclusions and deductions are less reliable than if they were derived from information contained on the tax returns. The reliability of the statewide estimates is also affected by the accuracy of the estimates at the national level.

The Department has identified 37 exclusions and deductions from federal income that represent passive tax expenditures at the state level. Table 1 (federal exclusions) and Table 2 (federal deductions) show the Department's estimates of passive tax expenditures since fiscal year 1990. Pension contributions and earnings, employer contributions to employee health insurance plans, and untaxed Medicare and Social Security benefits account for the greatest proportion of excluded income. These items increased from 65% of excluded income in fiscal year 1990 to 70% of excluded income in fiscal year 1995. Overall, the estimated federal exclusions have averaged about 39% of all tax expenditures under the individual income tax system.

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* The use of JCT data precludes estimating passive tax expenditures for the current or prior tax year.

Table 1: Estimated Exclusions From Federal Income (Thousands of Dollars), FY90-FY95

	FY90	FY91	FY92	FY93	FY94	FY95
Pension contributions & earnings	$31,740	$33,620	$34,580	$35,978	$37,406	$38,976
Contributions for health insurance	20,660	24,132	23,560	26,455	32,062	35,529
Untaxed Social Security benefits	12,563	13,346	14,923	15,393	25,329	26,598
Untaxed Medicare benefits	4,677	5,192	6,386	7,417	12,899	14,407
Capital gains at death	2,226	3,353	4,437	4,888	8,841	9,659
Deferrals of capital gains on sale of home	6,933	7,561	7,293	7,679	8,881	9,262
Individual retirement plans	7,108	7,556	6,088	6,366	6,539	6,817
Invest. income on life insur. & annuities	3,760	4,115	4,824	5,275	5,770	6,345
Cap. gain on sale of home by persons 55+	2,303	2,529	2,409	2,538	3,006	3,115
Miscellaneous fringe benefits	2,663	2,884	2,776	3,015	2,903	3,096
Workers' compensation benefits	2,081	2,329	1,591	1,656	2,149	2,234
Cafeteria plan benefits	1,061	1,623	1,859	2,221	1,956	2,040
Employer-provided group term life	1,184	1,251	1,269	1,333	1,570	1,654
Armed forces benefits	1,184	1,205	1,333	1,353	1,288	1,288
Veterans' benefits	1,004	1,050	1,031	1,076	1,095	1,139
Income earned abroad	Minimal	Minimal	947	967	1,010	1,030
Cancellation of farmer/rancher debt	Minimal	Minimal	Minimal	Minimal	544	356
Scholarship income	268	314	367	387	322	366
Employee meals and lodging	582	603	516	516	322	322
Investment income of benefit organization	314	335	322	322	322	322
Employer-provided child care	180	294	193	238	302	322
Public assistance benefits	201	201	238	258	258	302
Education savings bonds	NA	NA	44	109	129	129
Exemption from imputed interest rules	67	113	129	129	129	129
Like-kind exchanges	Minimal	Minimal	129	129	129	129
Rental value of ministers' homes	134	134	129	173	129	129
Other exclusions from federal income	2,715	3,065	256	256	400	400
Interest on Montana state & local bonds	NA	NA	NA	NA	NA	NA
Total	$105,608	$116,805	$117,629	$126,127	$155,690	$166,095

Source: Montana Department of Revenue, Tax Expenditure Report for the State of Montana, various years
Note: "NA" means not available

Some of the items listed in Table 1, such as pension contributions and earnings, individual retirement plans, and deferral of capital gains on the sale of a home, are not strictly exclusions of income but rather a deferral of income. These activities are usually taxed when income (e.g., retirement benefits) is received in later years but at presumably lower rates.

Federal Deductions From Income: Federal deductions from income (Table 2) account for a much smaller proportion of total tax expenditures under the individual income tax system. They have averaged about 2% of the total since fiscal year 1990.

Table 2: Estimated Deductions From Federal Income (Thousands of Dollars), FY90-FY95

	FY90	FY91	FY92	FY93	FY94	FY95
Accelerated depreciation	$4,299	$4,538	$3,163	$3,401	$4,274	$4,448
Cash accounting for agriculture	NA	NA	193	149	816	816
Expensing certain ag. multiperiod production costs	Minimal	Minimal	129	84	644	644
Regulated invest. co. admin. deductions	NA	NA	302	367	431	495
Dependent exemption for students age 19-23	201	201	193	193	431	451
Expensing exploration & development costs	381	402	322	367	230	230
Excess % over cost depletion	268	268	193	193	230	230
Amortization of business startup costs	88	67	129	129	129	129
Other deductions	155	88	64	64	200	200
Total	$5,392	$5,564	$4,688	$4,947	$7,385	$7,643

Source: Montana Department of Revenue, Tax Expenditure Report for the State of Montana, various years
Note: "NA" means not available

The largest component in this category is the deduction for accelerated depreciation. Depreciation, the decrease in value of business assets (i.e., rental buildings, other buildings, and equipment) from wear and obsolescence, is a proper deduction in the production of income. Typically, straight-line depreciation represents the useful life of an asset. However, accelerated

depreciation* allows larger deductions in the earlier years of the asset, and the accelerated depreciation schedules may involve shorter asset lives. Depreciation in excess of straight-line depreciation schedules for an asset's economic life is considered a tax expenditure.** The amounts shown for accelerated depreciation reflect the difference between accelerated depreciation schedules and straight-line schedules. Other items listed on Table 2 are relatively minor components.

Montana Exclusions and Personal Exemptions: Montana law provides for certain reductions and certain additions to federal adjusted gross income to arrive at Montana adjusted gross income. Reductions to income are considered tax expenditures because they are usually designed to benefit only specific taxpayers. Existing reductions to income would be unaffected by the enactment of House Bill No. 671. However, under House Bill No. 671, married taxpayers, both of whom have earned income, who file a joint return would be entitled to an exclusion, not to exceed $3,000, equal to 10% of the earned income of the spouse earning the lesser amount. This exclusion would be shown as a tax expenditure item.

Table 3 shows the estimated tax expenditures for Montana-specific exclusions and exemptions. These estimates are generally more reliable than the estimates for passive tax expenditures because most information is obtained from Montana tax returns.

The exclusion of pension and annuity income up to $3,600 is the single largest Montana exclusion. The amounts shown for fiscal years 1992 and 1993 include the estimated amounts for the exemption of all retirement income received by federal retirees, as well as the exemption of all retirement income received by Montana state and local retirees. In 1989, the U.S. Supreme Court

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* "Accelerated" depreciation schedules have been part of the federal tax codes since 1946 and have been revised many times since then, including in the Economic Recovery Tax Act of 1981 and the Tax Reform Act of 1986.

** Recall that the federal OMB considers accelerated depreciation part of the general tax law and is, therefore, not a tax expenditure.

ruled in Davis v. Michigan Dept. of Treasury* that different tax treatment of federal retirement income and state and local retirement income was discriminatory. Although the Montana Legislature did not respond to the Davis decision in 1989, the Department concluded that all federal retirement income would be exempt from taxation. The estimates for fiscal years 1992 and 1993 reflect that exemption.

During the 1991 Regular Session, the Legislature equalized the taxation of retirement income (Senate Bill No. 226) by excluding up to $3,600 (phased out at $2 for every $1 of federal adjusted gross income in excess of $30,000), regardless of source. As a result, the "actual" tax expenditure for the retirement exclusion is probably about one-fourth of the estimated amounts shown in fiscal years 1992 and 1993. The estimates for the retirement exclusion in fiscal years 1994 and 1995 reflect the new method of taxing retirement income.

Other tax expenditures that benefit older Montanans include an additional personal exemption for individuals 65 years of age and older** and the interest exclusion of up to $800 for individuals 65 years of age and older. When combined with the retirement exclusion, these benefits accounted for about 44% of the total estimated Montana exclusions in fiscal years 1994 and 1995.***

The estimated tax expenditures for "other exclusions" include disability income, wages covered by federal targeted jobs credit, land sales to beginning farmers, income earned by an Indian on an Indian reservation, etc. These items cannot

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* Davis v. Michigan Dept. of Treasury, 489 U.S. 803, 103 L.Ed.2d 891, 109 S.Ct. 1500 (1989).

** Personal exemptions (and deductions) are subtracted from Montana adjusted gross income to determine taxable income. House Bill No. 671 would increase each personal exemption from $1,360 (after indexing) to $2,710 (before indexing).

*** The personal exemption for persons 65 years of age and older shown on Table 3 also includes amounts for the blind and disabled.

be estimated separately because they are reported on a single line on the tax return.[3]

Table 3: Estimated Montana Exclusions and Deductions From Individual Income (Thousands of Dollars), FY90-FY95

	FY90	FY91	FY92	FY93	FY94	FY95
EXCLUSIONS & EXEMPTIONS						
Retirement income	$8,204	$8,445	$20,961	$24,136	$6,817	$7,399
65+ & blind exempt.	4,416	4,791	5,033	5,427	4,078	4,348
Unemployment benefits	NA	NA	NA	NA	2,209	2,251
Interest exclusion 65+	1,786	1,859	1,697	1,772	1,922	2,019
Capital gains exclusion	NA	NA	1,552	1,381	1,185	1,094
Tip income	NA	NA	NA	NA	330	338
Other exclusions	8,462	8,729	12,835	13,552	12,835	13,552
Total	$22,868	$23,824	$42,078	$46,268	$29,376	$31,001
ITEMIZED DEDUCTIONS						
Federal income taxes	$63,949	$68,065	$97,011	$102,424	$90,936	$93,329
Mortgage interest	25,536	26,762	26,301	26,959	31,646	31,891
Contributions	8,970	9,523	10,670	10,977	12,872	13,029
Property taxes	9,920	10,370	8,102	8,248	11,248	11,350
Medical expenses	4,986	5,226	7,447	8,178	9,380	10,078
Misc. deductions	4,955	5,079	5,236	5,287	6,770	6,712
Invest./personal interest	10,499	10,666	2,574	2,505	2,595	2,507
Other taxes	631	644	1,466	1,502	2,070	2,093
Long-term care insurance	0	0	0	0	440	450
Moving expenses	528	551	823	813	399	387
Casualty/theft losses	249	267	234	237	109	108
Child/dependent care	210	219	84	70	61	52
Total	$130,433	$137,372	$159,948	$167,200	$168,526	$171,986

Source: Montana Department of Revenue, Tax Expenditure Report for the State of Montana, various years
Note: "NA" means not available

Itemized Deductions: Table 3 also shows tax expenditures for itemized deductions. Except for deductions for federal income taxes paid, child and dependent care expenses, and long-term care insurance premiums, Montana's itemized deductions are passive in nature because they are tied to allowable federal deductions.

Itemized deductions have been the largest component of tax expenditures under the individual income tax system, accounting for over 45% of individual income tax expenditures. The deduction for federal income taxes paid in the tax year is by far the single largest deduction. If House Bill No. 671 is approved by Montana voters, tax expenditure estimates for itemized deductions would no longer be necessary. However, the bill provides that all itemized deductions allowed to be carried forward under federal law may continue to be carried forward for 5 years for Montana tax purposes. These items would still be reported as tax expenditures until the end of the carryover period.

Montana Income Tax Credits: Montana law provides for a number of income tax credits that may be taken to further reduce or eliminate individual income tax liability. These credits would still be allowed under House Bill No. 671. Table 4 shows the major tax credits allowed under Montana law. The elderly homeowner or renter credit and the credit for taxes paid to other states have historically accounted for most of the credits.

The investment tax credit is equal to 5% (not to exceed $500) of the investment tax credit allowed under federal law. The federal Tax Reform Act of 1986 repealed this credit. The amounts shown in Table 4 for the investment tax credit reflect unused carryover of the repealed credits. "Other" credits (enacted prior to 1993) include the college contribution credit, the rural physician credit, the dependent care assistance credit, the employer health insurance credit, and the wind-powered generation equipment credit.

Table 4: Estimated Montana Individual Income Tax Credits (Thousands of Dollars), FY90-FY95

	FY90	FY91	FY92	FY93	FY94	FY95
Elderly homeowner/renter credit	$3,150	$3,200	$3,500	$3,500	$3,925	$4,040
Income taxes paid to other states	2,729	2,910	4,358	4,720	3,600	3,700
Investment tax credit	53	27	577	477	275	215
Elderly care credit	NC	NC	50	50	250	300
Contractor's gross receipts	62	62	114	124	200	200
Montana capital company	140	150	1,923	2,023	125	100
Installation of nonfossil fuel energy devices	45	43	55	55	110	90
Installation of energy conservation devices	100	100	100	100	100	100
Other credits	NA	NA	NA	NA	130	170
Total	$6,279	$6,492	$10,677	$11,049	$8,715	$8,915

Source: Montana Department of Revenue, Tax Expenditure Report for the State of Montana, various years
Note: "NA" means not available, and "NC" means no credit.

Tax Expenditures Under the Corporation License (Income) Tax

The Montana corporation income tax structure generally conforms to the federal definition of corporate taxable income. Federal taxable income is the starting point for determining a corporation's Montana tax liability. Several items are added (e.g., federal, state, or foreign income taxes paid, additions to reserves for bad debts, federal net operating losses) to and subtracted (e.g., bad debts charged off, Montana net operating losses) from the federal base. Except for Montana-specific tax credits, most tax expenditures under the corporation license tax are passive in nature because of conformity with federal law. As is the case for the individual income tax, federal exclusions and deductions from gross income are derived from national estimates by the JCT and prorated to Montana.

Table 5 shows the Department's estimates of tax expenditures related to federal exclusions and deductions and to Montana-specific tax credits for fiscal

years 1990 through 1995. Exclusions from federal income are but a small part of tax expenditures associated with the corporation license tax. Of much larger significance are deductions from income. Within this category, accelerated depreciation (depreciation in excess of straight-line depreciation) and expensing multiperiod timber costs account for two-thirds to three-fourths of the total.

Montana law provides for several tax credits against corporation license tax liability. The largest of these is the contractor's gross receipts tax credit. A contractor who performs public construction work in the state is required to pay an additional license fee equal to 1% of the gross receipts from the public contract. The additional license fee is allowed as a credit against the contractor's corporation license tax.

Table 5 also shows the estimated tax expenditures for the investment tax credit and the Montana capital company credit. Before its repeal at the federal level, the investment tax credit was available only to small business corporations (10 or fewer shareholders). As is the case under the individual income tax, the estimated amounts reflect the carryforward of unused credits. All corporations are eligible for the Montana capital company credit. This credit is equal to 50%, but not to exceed $150,000, of the investment in a regular capital company. In 1991, the Montana Legislature provided for an additional credit not to exceed $250,000 for investment in a qualified Montana small business investment capital company (Ch. 263, L. 1991). The credit may be applied against the corporation license tax or the coal severance tax. Unused credit amounts may be carried back for 3 years and carried forward for 15 years.

Table 5: Estimated Tax Expenditures Under the Corporation Income Tax (Thousands of Dollars), FY90-FY95

	FY90	FY91	FY92	FY93	FY94	FY95
EXCLUSIONS FROM FEDERAL INCOME						
Income of foreign sales corp.	$155	$174	$167	$187	$170	$178
Investment income on life insurance & annuities	256	315	179	190	118	153
Other	164	164	253	253	200	200
Total	$575	$653	$599	$630	$488	$531
DEDUCTIONS FROM FEDERAL INCOME						
Accelerated depreciation	$8,410	$9,092	$6,110	$6,916	$5,809	$5,975
Expense multiperiod timber costs	1,630	1,630	1,462	1,799	1,558	1,558
Inventory property sales source	1,297	1,461	601	657	452	471
Agricultural cash accounting	NA	NA	450	450	389	389
Charitable contributions	560	615	537	560	313	341
Employee stock ownership plans	164	164	369	414	300	300
Excess of % depletion over cost depletion	950	998	994	1,136	279	279
Expense exploration & development costs	(1,045)	(665)	0	47	209	279
Expense R & D expenditures	280	312	288	313	201	204
Completed contract rules	(4,308)	(2,346)	73	329	105	105
Other deductions	533	437	417	45	200	200
Total	$8,471	$11,698	$11,301	$12,666	$9,815	$10,101
MONTANA CREDITS						
Contractor's gross receipts	$500	$500	$500	$479	$1,000	$1,000
Investment tax credit	70	30	220	200	300	300
Montana capital company credit	200	250	165	141	115	115
Other credits	500	500	200	184	100	100
Total	$1,270	$1,280	$1,085	$1,004	$1,515	$1,515

Source: Montana Department of Revenue, Tax Expenditure Report for the State of Montana, various years
Note: "NA" means not available

In the tax expenditure report issued for fiscal years 1990 and 1991 and the tax expenditure report issued for fiscal years 1992 and 1993, "other" credits included only the tax expenditures associated with the credit for the interest differential for low-interest energy loans and installations provided by public utilities and financial institutions.* In recent years, several additional credits, including the college contribution credit, employer health insurance credit, and dependent care credit, have been enacted into law. The total tax expenditures for these new credits, along with the interest differential credit and the new or expanding industry credit, were estimated to be $100,000 for fiscal years 1994 and 1995.

Natural Resource Tax Expenditures

Natural resource tax expenditures apply to taxes imposed on the production of minerals. Natural resource tax incentives are intended to encourage additional mineral exploration and development, to promote continued production, and to extend the economic life of mineral projects.

Table 6 shows the estimated tax expenditures associated with mineral production. Under current law, the number and level of tax expenditures associated with natural resource production are limited. Since fiscal year 1992, the exemption from the natural gas severance tax (2.65% on the gross taxable value of natural gas) on the first 30,000 cubic feet of natural gas from a well producing 60,000 cubic feet or less a day (referred to as "stripper" natural gas) has accounted for most of the natural resource tax expenditures. In addition, natural gas production in excess of 30,000 cubic feet a day from a stripper well is taxed at 1.59%, rather than at 2.65%. The tax expenditures associated with the reduced rate on stripper natural gas are included in the "other" category on Table 6.

"New oil and natural gas production" (production from a well that has not produced oil or natural gas in the immediately preceding 5 years) was formerly

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* House Bill No. 680 (Ch. 535, L. 1993) eliminated this credit for loans made after July 1, 1995. Instead, a public utility may finance the loans through the utility's rate base.

exempt from the oil severance tax (5% of the total gross value) or from the natural gas severance tax (2.65% of the total gross value). The exemption applied to the first 24 months of production. However, the exemption for both oil and natural gas terminated on the date that the Governor certified that the price of West Texas intermediate crude oil reached $25 a barrel. Executive Order No. 9-90 terminated the exemption effective August 8, 1990. As a result, the estimated amount shown on Table 6 in fiscal year 1991 for the severance tax exemption for new oil and gas production would not apply.

Table 6: Estimated Natural Resource Tax Expenditures (Thousands of Dollars), FY90-FY95

	FY90	FY91	FY92	FY93	FY94	FY95
Natural gas stripper gas	$633	$641	$663	$766	$1,154	$1,168
Coal severance tax exemption	231	187	205	205	122	122
New coal production tax credit	5,485	2,639	0	0	0	0
Severance tax exemption on new oil and gas production	787	812	0	0	0	0
Other	176	177	134	145	160	160
Total	$7,312	$4,456	$1,002	$1,116	$1,436	$1,450

Source: Montana Department of Revenue, Tax Expenditure Report for the State of Montana, various years

A similar oil severance tax exemption applied to the first 5 barrels of average daily production from an oil well that produces less than 10 barrels a day (stripper oil well). That exemption terminated on August 24, 1990, when the Governor certified by Executive Order No. 12-90 that the price of West Texas intermediate crude oil reached $30 a barrel. That Executive Order also terminated the reduced severance tax rate of 3% on stripper oil in excess of 5 barrels a day. Tax expenditure estimates for oil stripper wells were not included in the Department's first tax expenditure report.

The severance tax on incremental oil production from a tertiary recovery project is 2.5%. The Department notes that the tax expenditures associated with the reduced rate are minimal.[4]

In 1985, the Montana Legislature, in order to encourage increased coal production in the state, enacted House Bill No. 607 (Ch. 636, L. 1985) to provide a temporary tax credit against the coal severance tax for incremental production in excess of the producer's base production level and the purchaser's base consumption level. The credit was extended in 1987 (Ch. 608, L. 1987) and in 1989 (Ch. 31, L. 1989) and was combined with reductions in the coal severance tax rates. The credit last applied to incremental production sold before July 1, 1991. Table 6 reflects the estimated amounts of the credit for fiscal years 1990 and 1991.

A coal producer is exempt from the coal severance tax on the first 50,000 tons of coal production, unless the producer mines more than 50,000 tons, in which case the exemption applies only to the first 20,000 tons of production. Table 6 shows the estimated amounts associated with this exemption.

In addition to the reduced severance tax rate on stripper gas production in excess of 30,000 cubic feet, tax expenditure estimates under "other" include the exemption on the first $250,000 of production subject to the metal mines license tax.

Property Tax Expenditures

Article VIII, section 5, of the Montana Constitution provides that the Legislature may exempt from taxation the property of federal, state, and local governments; institutions of purely public charity, nonprofit hospitals, churches, and educational institutions; and any other class of property.

Most property tax exemptions are provided for in Title 15, chapter 6, part 2, MCA. Because most tax-exempt property (e.g., business inventories, certain agricultural products, minerals, down-hole equipment in oil and gas wells) is not assessed, the Department is unable to accurately estimate tax expenditures for most tax-exempt property.

Table 7 shows the tax expenditures that the Department can estimate for certain property tax exemptions and reduced property tax rates. The amounts shown in the table would reflect foregone revenue to local taxing jurisdictions, as well as to the university mill levy and school equalization.

Table 7: Estimated Property Tax Expenditures (Thousands of Dollars), FY90-FY95

	FY90	FY91	FY92	FY93	FY94	FY95
Reduced rates for low-income property	$1,250	$1,200	$1,400	$1,400	$1,500	$1,500
"New" oil net proceeds exemption	2,289	2,913	1,535	2,419	808	904
"New" gas net proceeds exemption	866	1,112	819	973	588	750
Reduced rate for "new industry"	3,125	2,360	100	Minimal	180	180
Business inventories	NA	NA	NA	NA	NA	NA
Agricultural products	2,200	2,200	NA	NA	NA	NA
Total	$9,730	$9,785	$3,854	$4,792	$3,076	$3,334

Source: Montana Department of Revenue, Tax Expenditure Report for the State of Montana, various years
Note: "NA" means not available

New production from an oil or natural gas well is exempt from net proceeds taxation for the first 12 months of production (15-23-612, MCA).* The 1-year exemption of new production of oil and gas has typically accounted for the largest property tax expenditures.

Low-income property owners are eligible for a reduction in the tax rate applied to the first $80,000 or less of market value of residential property, including land and improvements (15-6-134, MCA). In recent years, this tax expenditure has accounted for a substantial portion of tax expenditures under the property tax system.

New industrial property, including land, buildings, machinery, and fixtures used by a new industry, is taxed at 3% of the market value of the property

* Net proceeds is the gross sales proceeds of oil or natural gas produced, less royalties paid in cash or apportioned in kind. The tax rate for new oil production is 7% of the net proceeds, and the tax rete for new gas production is 12% of the net proceeds.

(15-6-135, MCA). Prior to 1991, a new industry included only mining and manufacturing concerns. In 1991, the Montana Legislature extended the reduced rate to transportation, warehousing, or distribution of commercial products industries, provided that the industry earned 50% of its gross income from out-of-state sales (Ch. 694, L. 1991). Since fiscal year 1992, tax expenditures associated with new industrial property have been relatively insignificant.

SUMMARY AND CONCLUSION

Table 8 summarizes the estimated tax expenditures by type of tax for fiscal years 1990 through 1995. The individual income tax has accounted for well over 90% of all estimated tax expenditures in Montana.* (See also Table 10, page 63.) Most individual income tax expenditures (including most Montana itemized deductions) are passive in nature because the Montana individual income tax law conforms closely with federal law. The relative proportions of each component of individual income tax expenditures, as well as the overall amounts, may change significantly if House Bill No. 671 is approved by the voters. Recent changes in the federal individual income tax law (e.g., the revised taxation of Social Security benefits) may also affect the level of tax expenditures in future years.

Most tax expenditures associated with the corporation license tax are also passive in nature. Corporation license tax expenditures have typically accounted for less than 4% of all tax expenditures. If, however, net operating loss carrybacks and carryforwards were considered a tax expenditure item, total corporation license tax expenditures would be relatively more important.

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* Because most property tax expenditures associated with exempt property are not estimated, the 90% amount overstates the proportion of total tax expenditures attributable to the income tax.

Table 8: Summary of Estimated Tax Expenditures for All Taxes (Thousands of Dollars), FY90-FY95

	FY90	FY91	FY92	FY93	FY94	FY95
PERSONAL INCOME TAX						
Federal exclusions	$105,608	$116,805	$117,629	$126,127	$155,690	$166,095
Federal deductions	5,392	5,564	4,688	4,947	7,385	7,643
Montana exclusions	22,868	23,824	42,078	46,268	29,376	31,001
Montana deductions	130,433	137,372	159,948	167,200	168,526	171,986
Montana credits	6,279	6,492	10,677	11,049	8,715	8,915
Total	$270,580	$290,057	$335,020	$355,591	$369,692	$385,640
CORPORATION INCOME TAX						
Federal exclusions	$575	$653	$599	$630	$488	$531
Federal deductions	8,471	11,698	11,301	12,666	9,815	10,101
Montana credits	1,270	1,280	1,085	1,004	1,515	1,515
Total	$10,316	$13,631	$12,985	$14,300	$11,818	$12,147
NATURAL RESOURCE TAXES	$7,312	$4,456	$1,002	$1,116	$1,436	$1,450
PROPERTY TAXES	$9,730	$9,785	$3,854	$4,792	$3,076	$3,334
TOTAL	$297,938	$317,929	$352,861	$375,799	$386,022	$402,571

Source: Montana Department of Revenue, Tax Expenditure Report for the State of Montana, various years

Natural resource tax expenditures and property tax expenditures are relatively insignificant. However, reported property tax expenditures do not fully account for all property that is exempt from taxation.

It must be reemphasized that the information presented in this report is intended to convey only the relative magnitude of tax expenditures in Montana. Although tax expenditures are analogous to direct expenditures, the elimination of one or more tax expenditures, particularly under the individual income tax or the corporation license tax, will not necessarily generate a corresponding

additional amount of revenue because of the interactive effects within the tax structure and because of likely changes in taxpayer behavior.

Tax expenditures associated with each tax system will be examined in more detail in Chapter Four. The ultimate goal of the examination is to encourage the Montana Legislature to develop a systematic review and oversight process related to these tax expenditures.

ENDNOTES

1. Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 1993-1997, (Washington, D.C.: U.S. Government Printing Office, April 24, 1992), p. 8.

2. Montana Department of Revenue, Tax Expenditure Report for the State of Montana: Fiscal Years 1994 and 1995 (Helena: Montana Department of Revenue, January 1993), p. 3.

3. Ibid., p. 43.

4. Montana Department of Revenue, Tax Expenditure Report for the State of Montana: Fiscal Years 1992 and 1993 (Helena: Montana Department of Revenue, January 1, 1991), p. 66.

CHAPTER THREE

REVIEW OF SELECTED STATES' TAX EXPENDITURE REPORTING

INTRODUCTION

Twenty-seven states issue annual or biennial tax expenditure reports. Several states (including Hawaii, Idaho, Missouri, and South Carolina) issue tax expenditure reports without a statutory requirement. In each of the 27 states, a tax expenditure report is prepared by the Executive Branch. In both California and Maine, a separate and more comprehensive report is prepared by the Legislative Branch. Montana is one of the few states in the Rocky Mountain region and the Pacific Northwest that prepares a tax expenditure report. Arizona, California, Idaho, and Washington are the only other states in the two regions that prepare tax expenditure reports. The North Dakota Legislature is conducting an interim study of tax preferences in that state, while South Dakota does not prepare a report.

The quality and comprehensiveness of tax expenditure reports vary considerably from state to state. This chapter summarizes the significant features of the tax expenditure reports prepared by selected states: Arizona, California, Delaware, Idaho, Louisiana, Maine, Michigan, New York, North Carolina, and Washington. This chapter focuses on the information required to be included in each state's tax expenditure report, the taxes covered by the report, the degree to which tax expenditures are evaluated, and the extent to which the tax expenditure report is reviewed by the state's legislature. The basic format of the chapter is to describe the general features of each state's tax expenditure (including whether the state incorporates into its report federal "passive" tax expenditures under the state's individual and corporation income taxes) and then to discuss the legislative review of the report. In a few cases (e.g., Arizona and Washington), a more detailed discussion is presented on the tax expenditures associated with particular taxes because this format better highlights the general features of the states' tax expenditure reports.

The term "tax expenditure" can be controversial, so several states have chosen a euphemism that means the same thing. When another term has been adopted by a particular state, that term is used in the evaluation of the state's report.

ARIZONA

General Description

The Arizona Department of Revenue is required to issue a report to the Governor and the Legislature detailing the approximate costs in lost revenue for all state tax expenditures. Tax expenditures are estimated for the luxury tax (excise taxes on tobacco products and alcoholic beverages), the transaction privilege (sales tax) and severance tax, the individual income tax, the corporation income tax, and the property tax. In addition to numerical estimates, the report contains a brief description of each tax expenditure provision. Tax expenditure items are not evaluated on the basis of tax equity, economic efficiency, or desirability.

Tax expenditures are estimated retrospectively. Estimates for the luxury tax, sales tax, and property tax are made for the fiscal year just ended. Individual income tax expenditures and corporation income tax expenditures are estimated for the most recent tax year for which data is available. Passive tax expenditures for individual and corporation income taxes are not estimated.

Luxury Tax

In Arizona, spirituous liquor is taxed at $3 a gallon. Beer and wine are taxed at much lower rates per gallon. The different rates applied to beer and wine constitute a tax expenditure. In fiscal year 1992, an additional $317 million would have been raised if the $3 a gallon tax rate had been applied to beer and wine sales. Exemptions for alcoholic beverages are allowed for sales to the military, for products authorized for destruction, and for broken bottles.

Exemptions for tobacco products include sales to Indian reservations and to the military, tax stamp discounts, and refunds for cigarettes authorized for destruction.

Individual Income Tax

Individual income tax expenditures are estimated for the latest tax year for which data is available. Tax expenditures are calculated for Arizona-specific exemptions, subtractions from income, deductions, and credits. Exemptions of income includes personal and dependent exemptions and additional exemptions for the blind and elderly. Subtractions from income include interest on U.S. obligations, pensions, Social Security and railroad retirement benefits included on the federal tax return, Arizona lottery winnings, and other subtractions. Deductions include the standard deduction or itemized deductions. The major credits allowed include a property tax or renter's credit for the elderly and a credit for taxes paid to other states.

Corporation Income Tax

As is the case for individual income taxes, corporation income tax expenditures are estimated for the latest tax year for which data is available. Corporate taxpayers in Arizona are allowed to subtract Arizona-based net operating losses and commercial tax credits. Arizona net operating losses and commercial credits are the only items included in the tax expenditure report.

Property Taxes

All federal, state, county, and municipal property is exempt from taxation under the Arizona Constitution. The property of certain education, charitable, and religious institutions not used for profit is exempt from taxation by statute. A portion of the property of widows, widowers, and the disabled whose income is below a certain level is also exempt from the property tax. Tax expenditures for all exempt property are calculated by applying the state education property tax rate to the value of the exempt property.

Arizona law provides for different assessment ratios to determine the value of property subject to taxation. The assessment ratios vary in value from 5% (historic property) to 100% (producing oil and gas property) of market value. The Arizona tax expenditure report shows the additional amount of state revenue that would be raised by the education property tax if all property were taxed at 100% of market value.

Legislative Review

Although each member of the Arizona Legislature receives a copy of the report, there is no formal legislative review process to evaluate tax expenditures in Arizona.

CALIFORNIA

General Description

In 1971, California became the first state to adopt tax expenditure reporting. The Governor is required to submit a tax expenditure report with the proposed budget. The report identifies major state and local tax expenditures and contains the Governor's recommendations regarding selected tax expenditures. The report, however, is not comprehensive and usually contains only a few pages.[1] In 1985, the California Legislature required the California Office of the Legislative Fiscal Analyst to prepare a biennial report on tax expenditure programs. The report provides revenue loss estimates for the preceding fiscal year, the current fiscal year, and the succeeding fiscal year. In addition, the report cites the statutory authorization and provides a description, the rationale, and a brief analysis of each tax expenditure.*[2]

Tax expenditure estimates are prepared for the personal income tax and the bank and corporation tax, the sales tax, excise taxes on alcohol and cigarettes, fuel taxes, insurance taxes, and local property taxes.

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* Cutbacks in state government in California have resulted in the suspension of the Fiscal Analyst's report. The last report was published in May 1991.

The Fiscal Analyst's report contains estimates for passive tax expenditures to the extent that California law specifically conforms with federal law. The report also lists as a tax expenditure the carryforward of net operating losses. Unlike most other states that impose a personal income tax, California provides for personal and dependent credits, rather than personal and dependent exemptions. This method promotes vertical equity because the credit ($58 for single returns and dependents and $116 for joint returns, all indexed for inflation) is worth more to taxpayers in lower-income tax brackets.

The report provides tax expenditure estimates for a wide variety of exempt property and, like Arizona, includes exempt public property. The exemptions are categorized by type of activity, such as agriculture-related property or business-related property. The report lists 71 local property tax expenditures in 11 different categories. The report notes that local property tax exemptions have an impact on state finances because the state generally makes up any property tax revenue lost to school districts.

Legislative Review

The tax expenditure report prepared by the California Fiscal Analyst is one of the most comprehensive of the reports reviewed. The reports issued in 1987 and 1988 included detailed analysis of selected tax expenditures as well as recommendations for changes. During the 1987 California legislative session, three of the four recommendations proposed by the Fiscal Analyst were considered by the Legislature's tax and revenue committees and were ultimately adopted into law.[3] The last report issued by the Fiscal Analyst does not contain specific recommendations for modifying tax expenditures but does present an action plan for reviewing tax expenditures. The action plan for legislative review of tax expenditures includes the following:

- review and agree upon the basic rationales and objectives of individual tax expenditure programs (TEPs);
- review the available evidence on the overall effectiveness and economic efficiency of individual TEPs;

- take the following actions with regard to individual TEPs:
  - eliminate TEPs whose rationales and objectives are no longer valid or of low priority;
  - eliminate or modify TEPs that are not accomplishing their objectives;
  - eliminate TEPs that are not cost-efficient (even if they are effective) and, if appropriate, replace them with either tax expenditure or direct expenditure programs that are cost-efficient; and
  - modify inadequately targeted TEPs so that they are better targeted to those who need or will respond to them, thus eliminating unintended windfalls.[4]

The report noted that a systematic review of tax expenditures could play an important role in addressing the state's budgetary crisis. Recently, California suspended the renter's credit and repealed the credit for child-care and dependent care expenses. The California Legislature also expanded the sales tax to certain previously exempt items.* It is not clear whether these measures resulted from an interest in a long-term review of tax expenditures in general or whether they were enacted simply as a means of raising revenue during a fiscal crisis.** The repeal of tax exemptions in California requires a supermajority vote.***

DELAWARE

General Description

The Delaware Department of Finance, Division of Revenue, is required by statute to prepare a tax preference report. The tax preference report issued in 1988 analyzed the impact of all state-specific and passive tax preferences. The

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* The base broedening of the sales tax was subsequently overturned by voter initiative.

** The renter's credit and the credit for child and dependent care expenses were among the largest tax credits under California's individual income tax.

*** In 1979, California voters approved an initiative measure that requires a two-thirds legislative majority to increase state taxes.

latest report, issued in November 1993, summarized tax preferences adopted or eliminated since 1988 and presented a detailed analysis of state-specific preferences for the individual and corporation income taxes (exclusive of passive tax expenditures), the motor fuel tax, and the public utility tax. The report also listed a number of items (e.g., interest from U.S. obligations) that ostensibly meet the criteria for tax preferences but are excluded from the analysis and the reason for the exclusion. The report contains the following information:

- a description of the tax preference, its purpose, and its statutory citation;
- the estimated revenue loss for fiscal years 1993 and 1994;
- an assessment of whether the tax preference is the most effective means of achieving its stated purpose;
- an assessment of whether the tax preference is received by the intended beneficiary; and
- a statement of unintended effects.[5]

In Delaware, tax preferences are evaluated in terms of the criteria for a "good" tax system: adequacy and stability of revenue, equity among taxpayers, simplicity, and economic efficiency and competitiveness. For example, the report evaluated tax preferences allowed for elderly taxpayers. It noted that many of the tax preferences violate the principles of horizontal and vertical equity because of the "all or nothing" provision to qualify for certain preferences, the absence of a means test to qualify for other tax preferences, and the different treatment of different sources of income in determining eligibility for tax preferences. The report notes that nonmeans-tested tax preferences for the elderly have been justified on the grounds that the elderly as a group are less well-off than the general population. While that may have been true in the past, information from the Bureau of the Census shows that in 1989, the poverty rate among the elderly was slightly below that of the general population.[6] Because the report questioned some longstanding assumptions about the validity of tax preferences for the elderly, editorials

appearing in Delaware newspapers criticized the report as being against the elderly.[7]

Tax preferences are also evaluated in terms of achieving public policy goals outside the tax system. In Delaware, "the purpose of many business credits is to promote socially desirable behavioral changes, such as the development of [sound environmental] business practices".[8] For example, under the "green industries" tax credits, businesses may receive tax credits for reducing, recycling, or processing waste material. To qualify for the credits, a business engaged in the recycling or processing of waste material must also meet the eligibility requirements of Delaware's "Blue Collar Jobs Act". The report provided the following assessment of the green industries tax credits:

> During the first ten years of its existence, only 46 firms qualified for credits under the Blue Collar Jobs Act. Given . . . the nature of the qualifications requirements, the probability that a significant number of firms [engaged in recycling] . . . would qualify in any given year is remote. Moreover, the likelihood of a qualifying firm coming from an unestablished industry, like many types of recycling ventures, is even more remote.[9]

This kind of detailed assessment of tax expenditures, as well as the discussions of inadvertent effects, is rare among the tax expenditure reports surveyed for this report. Delaware may expand the analysis in future reports to include distributional patterns of tax preferences received under the individual income tax.[10] The Montana tax expenditure report provides this kind of information by income decile for Montana-specific exemptions and deductions.

Legislative Review

After the issuance of the 1988 report, the Delaware Legislature passed a bill that would have sunsetted all tax preferences. The Legislature soon realized the magnitude of its action and subsequently repealed the measure. Currently, there is no formal process for reviewing tax expenditures by the Delaware Legislature.[11]

IDAHO

General Description

Tax expenditure estimates in Idaho are prepared by the Division of Financial Management. There is no statutory requirement for a tax expenditure report. Tax expenditure estimates are reported in the General Fund Revenue Book. This publication also contains the Idaho economic forecast and general fund revenue projections for the state. Tax expenditures are estimated for the individual and corporation income taxes, the sales tax, the insurance premium tax, the cigarette tax, and the kilowatt hour tax. Estimates are presented for the current calendar or fiscal year, the 3 preceding calendar or fiscal years, and the next 2 calendar or fiscal years. Tax expenditures under individual and corporation income taxes and the insurance premium tax are estimated on a calendar year basis, while tax expenditures under the sales tax, the cigarette tax, and the kilowatt hour tax are estimated on a fiscal year basis.

The report cites the statutory authority for each tax expenditure and includes a brief description of its features, a summary of its legislative and judicial history, a comparison with other state and federal practices, and a description of any political controversy or unusual circumstances relating to the tax expenditure.[12]

Individual and Corporation Income Taxes

Idaho reports individual and corporation income taxes in the same section. Although the report includes exempt interest from federal obligations, estimates are limited to Idaho-specific tax expenditures. Tax expenditures are identified by uses of income not taxed (e.g., investment tax credit) or by sources of income not taxed (e.g., capital gains exclusion or retirement exclusion, including Social Security benefits and railroad retirement benefits taxed at the federal level).

The report contains a detailed description of the investment tax credit. The investment tax credit was reenacted in Idaho in 1987 following federal repeal of the credit under the Tax Reform Act of 1986. (In Montana, taxpayers may

claim only carryover amounts for the credit.) The report notes that the credit has had a volatile political history. An unsuccessful attempt was made in the Idaho Legislature to repeal the credit in 1987. A ballot measure to repeal the credit was also attempted, but it failed to obtain enough signatures to qualify for the ballot. Proponents for the credit claim that it provides an economic incentive for making capital investments, while opponents maintain that it subsidizes investments that would have been made anyway. The investment tax credit is the single largest tax expenditure under the individual income tax.

Idaho also reenacted the 60% capital gains exclusion from the sale of certain property following the exclusion's repeal at the federal level. Montana taxpayers are entitled to exclude 40% of the capital gains for installment sales entered into before January 1, 1987.

Legislative Review

There is little formal legislative review of the tax expenditure report. There is apparently a reluctance to overturn the "collective wisdom" of previous legislatures.[13]

LOUISIANA

General Description

The Louisiana Department of Revenue and Taxation is required to prepare an annual tax exemption budget. The report must include the following information:

- each tax exemption, its purpose, and its statutory citation;
- the estimated revenue lost to the state for the preceding 3 years and the estimated revenue loss to the state for the current fiscal year and the ensuing fiscal year;
- the estimated cost of administering each exemption;
- a determination of the tax exemption's effectiveness in fulfilling its original purpose (e.g., who are the beneficiaries) and of whether unintended or inadvertent

effects, benefits, or harm was caused by the exemption; and

- an assessment of whether the tax exemption is the most fiscally effective means of achieving its purpose and an assessment of whether the tax exemption simplifies or complicates the state tax laws.[14]

Tax exemption estimates are provided for consumption and excise taxes, individual and corporation income taxes, inheritance and gift taxes, natural resource and petroleum products taxes, and a variety of miscellaneous taxes. Exemptions mandated by the Louisiana Constitution are listed separately. Passive tax exemptions for the individual and corporation income taxes are not estimated. Under the individual income tax, personal and dependent exemptions, the standard deduction, and federal itemized deductions in excess of the standard deduction are all considered tax exemptions (expenditures). Federal income taxes paid are exempt under the Louisiana Constitution.

Although the reporting requirements for the Louisiana tax exemption report are some of the most comprehensive in the nation, there is little substantive detail provided beyond the actual tax exemption estimates. The description of beneficiaries is often a repetition of the statutory provisions or is some general statement that society as a whole benefits. Virtually every tax exemption, according to the report, is achieved "in a fiscally effective manner".

Legislative Review[15]

There has been little formal legislative review of the Louisiana tax exemption budget. Legislative interest in the report has varied, depending on which tax exemptions have been considered for repeal or modification. In 1993, the Senate Revenue and Fiscal Affairs Committee held several meetings on the report when several bills were being considered to repeal a number of tax exemptions. Most of the repeal measures failed. The Department of Revenue and Taxation intends to conduct research in an effort to better determine the beneficiaries of the major tax exemptions.

MAINE

General Description

Since 1983, the Governor of Maine has been required to include information on tax expenditures in the executive budget document. The document must specifically include:

> . . . the estimated loss in revenue during the last completed fiscal year and the fiscal year in progress, and the anticipated loss in revenue for each fiscal year of the ensuing biennium, caused by the tax expenditures provided in Maine statutes . . . .[16]

The document includes tax expenditures for the sales tax, the individual and corporation income taxes (these taxes are grouped together), excise taxes, fuel taxes, and property taxes (tree growth reimbursements and reimbursement of veterans' property taxes). The document includes estimates of items that are prohibited from taxation under federal law (e.g., interest on U.S. obligations). Tax expenditures under the individual income tax include personal exemptions and the standard deduction. Maine's individual and corporation income tax systems conform to federal provisions. As is the case in Montana, estimates of passive tax expenditures are derived indirectly from federal tax expenditures that are estimated by the JCT.

The Maine Joint Standing Committee on Taxation (Joint Committee) is required by law to review a portion of all tax expenditures each year. In 1978, the Maine Legislature directed the Joint Committee to review sales and use tax exemptions on a 2-year cycle. Under existing law, all tax expenditures contained in the sales, income, and insurance tax laws are reviewed by the Joint Committee on a 4-year cycle. The review must include the following information:

- a description of the purpose of the tax expenditure;
- a determination of the groups or individuals likely to benefit from the tax expenditure;

- an evaluation of the effectiveness of the tax expenditure;
- an estimate of the annual cost of the tax expenditure;
- a recommendation of the committee [relating to] the amendment, repeal, replacement, or retention of the tax expenditure; and
- an evaluation of the effectiveness of the procedures [used in the review of tax expenditures] and any recommendations for change.[17]

The review process includes Joint Committee meetings and public hearings. In 1993, the Joint Committee undertook a review of all sales tax expenditures. Because of cutbacks in state government funding, the Joint Committee believed that every expenditure, including tax exemptions, should be reviewed and that the public should participate in that review. The comprehensive review included a description of the tax expenditure, an estimate of the loss in revenue, and a summary of public comments.

Although the Joint Committee considered including food and services in the sales tax base, it concluded "that every one of the more than 100 sales tax exemptions was created for a reason and most of the exemptions still exist for reasons of good tax policy".[18] The tax exemptions were justified, for the most part, on the grounds of economic development. The Joint Committee also concluded that the review of tax expenditures should be conducted using more stringent criteria. Requests for new exemptions would not be granted unless they satisfied the new criteria. In addition, beneficiaries of existing exemptions would have to continually justify the rationale for the exemptions.

MICHIGAN

General Description

The Michigan Department of Management and Budget, in conjunction with the Michigan Department of Treasury, has been required to submit a tax expenditure report since 1979. The report is submitted as an appendix to the executive budget. The report presents summary information on state tax expenditures for the previous 3 fiscal years and detailed estimates for the fiscal

year just completed. Detailed estimates are presented for both state and local tax expenditures. The report also compares tax expenditures with direct expenditures by spending category. In fiscal year 1992, tax expenditures ranged from 2.1% of total expenditures (direct expenditures plus tax expenditures) for higher education to 90.4% of total expenditures for commerce.

The report makes a salient point regarding the impact of tax expenditures on the budget process:

> . . . tax expenditures are made first, regardless of direct expenditure needs. Direct expenditure needs then are ranked according to importance and made out of the remaining state revenue. Policy makers tend to see the amount of revenue available for appropriation as the amount of state revenue actually collected, rather than the amount of revenue that would be collected without tax expenditures.[19]

State Tax Expenditures

Tax expenditures are estimated for business privilege taxes, consumption taxes, individual income taxes, state property taxes, and transportation taxes. The report provides a brief description for each tax expenditure.

The single business tax (value-added tax) accounts for virtually all of the tax expenditures under business privilege taxes. The insurance company retaliatory tax and the oil and gas severance tax account for about 0.95% of business privilege tax expenditures.

Likewise, the sales and use tax accounts for almost all of the tax expenditures under consumption tax. Tax exemptions for beer, wine, and cigarettes are relatively insignificant.

Michigan imposes a flat tax on modified federal adjusted gross income. Tax expenditures for the income tax include both passive tax expenditures and Michigan-specific personal exemptions, adjustments to income, and credits.

Passive tax expenditures are estimated indirectly from federal tax expenditures estimated by the OMB. Michigan-specific tax expenditures are tabulated by income class.

Tax expenditures under the state property tax (inheritance taxes, intangible property taxes, and utility property taxes) and under transportation taxes (fuel taxes and motor vehicle taxes) are relatively small components of total tax expenditures in Michigan.

Local Tax Expenditures

The Michigan tax expenditure report also tabulates local tax expenditures under the general property tax and the city income tax. Tax-exempt government and personal property accounts for 80% of the tax expenditures under the general property tax. Tax exemptions for industrial facilities development (these must be approved by local governments) and diverted revenue associated with tax increment financing account for a large portion of the remaining tax expenditures under the general property tax. Reduced income tax rates for nonresidents account for most of the tax expenditures under the city income tax.

Legislative Review

In 1983, the Michigan House Taxation Committee created a tax expenditure review subcommittee. The subcommittee established criteria for evaluating new tax expenditures. Although the goal was to make deliberate decisions regarding tax expenditures, the subcommittee has not done anything on a systematic basis.[20]

NEW YORK

General Description

In his 1988 State of the State message, Governor Cuomo directed the Department of Taxation and Finance, in consultation with the Division of the Budget, to prepare an analysis of the technical and conceptual issues that would be involved in tax expenditure reporting in New York.[21] In February

1990, following a series of discussion papers on tax expenditure reporting, the Division of the Budget and the Department of Taxation and Finance published the first New York tax expenditure report. The report contained information on tax expenditures associated with the personal income tax, the business corporation franchise tax (income tax), and the sales and use tax. The estimates were made for the most recent year for which tax data was available. For example, in the initial report, personal income tax expenditures were reported for tax year 1987.

In addition to the numerical estimates, the report included the legal citation (including the citation of the Internal Revenue Code for passive tax expenditures) for each tax expenditure, the date when the provision was enacted, the date of repeal or sunset of the tax expenditure, and a brief description of each provision.

Full reporting of tax expenditures in New York has been phased in over a 5-year period. The 1995 report will contain estimates for all tax expenditures.

The format of the report now shows estimates for the current budget year and the previous 5 years for which data are available. The report also assigns a reliability level for each of the estimates, with "1" being the most reliable estimate and "4" the least reliable. For example, under the personal income tax, the Department of Taxation and Finance assigns the highest reliability (level 1) to estimates based on information from actual tax returns that have been verified for accuracy. It assigns level 2 to estimates based on unverified or incomplete information from actual tax returns. Level 1 and level 2 estimates generally apply to New York-specific deductions (including the standard deduction), exemptions (including dependent exemptions*), and various credits. Level 3 estimates are based on the federal Statistics of Income, an annual statistical report produced by the U.S. Department of the Treasury. The report contains Internal Revenue Service data on federal tax returns filed by New York residents. Average New York marginal tax rates are applied to

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* Taxpayers in New York are no longer entitled to claim a personal exemption.

aggregate data. These estimates generally apply to passive tax expenditures. Level 4 estimates are based on national tax expenditure estimates provided by the OMB or by the JCT. Estimates for passive tax expenditures are generally derived from OMB estimates because the OMB provides estimates for the previous fiscal year. This allows state passive tax expenditures to be estimated for previous years.

Most tax expenditure estimates for the New York sales tax are derived from nontax sources because vendors are required to report only taxable receipts. Government and industry publications are used to determine tax expenditures under the sales tax.

Legislative Review

In New York, the tax expenditure report is submitted 30 days after the Governor submits the executive budget. The tax expenditure report describes proposals in the executive budget that modify, add, or repeal specific tax expenditures. For example, the Governor had recommended that New York enact an earned income credit equal to 5% of the federal earned income credit for tax year 1994 and equal to 10% of the federal credit for tax years thereafter. The Report of the Fiscal Committees on the Executive Budget presents a summary of legislative action with respect to the Governor's recommendations regarding tax expenditures.

The tax expenditure report is considered by the Assembly Ways and Means Committee and the Senate Finance Committee during the budget hearing for the Department of Taxation and Finance. The public is invited to provide testimony on the tax expenditure report. Business interests usually support the various tax expenditures, while public advocacy groups are generally opposed. The opposition to tax expenditures tends to ebb and flow, depending on whether there is a budget surplus or budget deficit.[22]

The tax expenditure report may be consulted during consideration of various tax proposals. For example, the report was used to determine the revenue impact for a bill to expand the sales tax to certain services.

NORTH CAROLINA

General Description

The North Carolina Department of Revenue is required to prepare a report of tax expenditures contained in the state revenue laws. The North Carolina Legislature specified that the estimates be prepared only to the extent that they do not impair the other duties of the Department.

The principal value of the report is that it provides a detailed listing of each tax expenditure provided for in North Carolina law. However, actual estimates of tax expenditures are rare even in those cases in which the information should be readily available. For example, there are essentially no estimates for tax expenditures under the individual income tax except for a few credits. Perhaps the most interesting feature of the North Carolina report is the discussion of the controlled substance tax:

I. Exemptions.

> Controlled substances or counterfeit controlled substances possessed, delivered, sold, or manufactured by persons other than dealers is exempt from the tax . . . . [This section goes on to describe a dealer.]

II. Preferential tax rates.

> No comparison or rates on different types of controlled substances has been attempted, although differences exist.
>
> Comment: Rates were apparently based somewhat on street value of the specific controlled substance, the hazard to one's health of using, and the cost to society to combat.[23]

WASHINGTON

General Description

The Washington Department of Revenue is required to prepare a tax exemption report detailing for each tax expenditure "an estimate of the revenue lost from the tax exemption, the purpose of the tax exemption, the persons, organizations or parts of the population which benefit from the tax exemption, and whether or not the tax exemption conflicts with another state program".[24]

Washington's tax exemption report shows for the current biennium and the next biennium the estimated fiscal impact to the state of tax expenditures associated with the property tax, the sales and use tax, and the business and occupation tax (gross receipts tax), as well as several less important taxes. The report also compares tax expenditures with anticipated revenue. During the 1993-95 biennium, estimated tax expenditures are expected to exceed projected revenue by 6.4%.[25]

The report also provides local government tax expenditure estimates associated with the local property tax and local sales taxes. The estimates are also for the current biennium and the next biennium.

In Washington, county assessors are required to value exempt property; however, many assessors do not value exempt property. The Washington Department of Revenue employs seven or eight analysts to estimate the value of exempt property based on random sampling methods. Under Washington law, property taxes are allowed to grow 6% a year. As a result, property tax exemptions may result in a shift in the property tax burden rather than cause a loss in revenue to state and local governments.

Every 4 years, the Governor may make recommendations for the repeal or modification of tax expenditures. The Governor has seldom exercised this option.[26]

Legislative Review

The Senate Ways and Means Committee has the ostensible responsibility for reviewing the tax exemption report; however, little systematic review is undertaken.[27] In a practical sense, the tax exemption report may be used as a budget-balancing tool for new programs. The repeal or modification of a tax exemption may provide a source of revenue for the new program.

Few tax expenditures have been repealed in Washington. Typically, new exemptions are granted every year. Part of the reason for this is that Washington's tax system is highly unbalanced. The state relies heavily on the sales and use tax and the business and occupation tax. Both taxes are broad-based, and the rates, especially for the sales tax, are high. Oregon does not have a sales tax, and the sales tax rate in Idaho is lower. Given these circumstances, it is not unreasonable that exemptions would continually creep into the tax system.

SUMMARY AND CONCLUSIONS

The tax expenditure reports reviewed in this chapter are a broad representation of the kind of information presented by states that prepare tax expenditure reports. Based on the evaluation of the reports, it does not appear that there is a strong consensus at the state level regarding what exactly a tax expenditure is in all cases.

Four of the states reviewed (California, Maine, Michigan, and New York) estimate passive tax expenditures, while four (Arizona, Delaware, Idaho, and Louisiana) do not.* Arizona, California, Louisiana, Maine, and Michigan consider the personal (or dependent) exemption (or credit, as in California) or the standard deduction, or both, as tax expenditures. Finally, there is disparate treatment of items exempt from taxation under federal law or state constitutions. For example, Arizona and Idaho include interest on U.S. obligations as a tax expenditure, while Arizona, California, Idaho, Maine, and

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* North Caroline identifies passive tax expenditures in its report, but it does not estimate the revenue loss associated with those items.

Michigan tabulate tax expenditure estimates for tax-exempt public property (local, state, and federal property).

The Montana Department of Revenue includes in its estimates of tax expenditures passive tax expenditures and excludes personal and dependent exemptions, the standard deduction, and tax-exempt public property.

The reporting period for tax expenditure estimates also varies considerably among the states. Arizona reports tax expenditures retrospectively, based on the availability of data. Several of the other states provide historical estimates as well as estimates for the current fiscal year or the subsequent fiscal year or years. Although Michigan shows tax expenditures for the 3 previous fiscal years (including detailed estimates for the fiscal year just ended), that state's report cautions against compiling annual time series estimates. Changes in federal, state, and local laws will affect the number, type, and magnitude of tax expenditures. In addition, refinements in estimating methodology may change the estimates. For these reasons, tax expenditures may not be comparable across years.[28]

Louisiana, Michigan, and Washington compare tax expenditures with actual or estimated revenue collections. Michigan also compares tax expenditures with direct expenditures by spending category. These comparisons assist in understanding the fiscal impact of tax expenditures on the state budget.

States also differ on the level of analysis of tax expenditures within the state. California, Delaware, Idaho, and New York provide detailed discussions of the tax expenditures that should assist policymakers in their review of them. Unfortunately, a common theme that emerged in conversations with state tax officials was the apparent weakness or lack of consistency on the part of legislatures in committing to systematic reviews of tax expenditures.

There may be several reasons why state tax expenditure reports have not always been the effective tools that they were envisioned to be. First, most

tax expenditures are estimated in isolation, without consideration of changes in taxpayer behavior. The impact of repealing a particular expenditure will never be recorded in an accounting report. Indeed, the real impact of the repeal may never be known. There may be a reluctance on the part of legislators to make policy changes based on numbers that cannot be taken at face value. This problem is especially significant for income taxes, an area in which changes in the tax law may have a significant impact on taxpayer behavior. Second, systematic review of tax expenditures imposes additional burdens on both the Executive and Legislative Branches. Policymakers may be more interested in dealing with issues that are more familiar and routine. Third, there may exist an underlying suspicion that the repeal or modification of tax expenditures is simply a backdoor method of raising revenue, when in fact there may be more interest in constraining the growth of revenue. Fourth, the tax expenditure report may be used as a battering ram against the party in power. One party may use the report to accuse the other of giving tax breaks to special interests, while the other party may use it to accuse the first of assaulting the taxpayer. It may be better, politically, not to expose the details.

Whether the reasons are valid or not is probably beside the point. Agencies that prepare tax expenditure reports, including the Montana Department of Revenue, invest considerable time and resources to ensure, to the extent possible, the reliability of the tax expenditure estimates. Although the information contained in tax expenditure reports is often imperfect, it is generally presented in a manner that allows policymakers to make informed judgments about particular tax expenditures. Oftentimes, however, the kind of information that may be the most useful cannot be quantified because of technical constraints or resource limitations. That does not mean that the level of detail and analysis cannot be improved upon. The usefulness of the Montana tax expenditure report could be enhanced by incorporating some of the more desirable elements of other states' reports (just as the usefulness of other states' reports could be enhanced by adopting some of Montana's) and by developing a more sophisticated level of analysis. However, substantial improvements to Montana's tax expenditure report cannot be achieved without

commitment of additional resources. Such changes should not be undertaken unless the Montana Legislature is willing to improve the review process used for the report.

ENDNOTES

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4. Analysis of the 1991-92 Tax Expenditure Budget, p. 12.

5. The Delaware Tax Preference Report (Dover: Delaware Department of Finance, Division of Revenue, November 16, 1993).

6. Ibid.

7. David Gregor, Director, Bureau of Tax Policy, Delaware Department of Finance, Division of Revenue, telephone conversation, May 5, 1994.

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15. Ellen Rhorer, Director, Research and Technical Services, Louisiana Department of Revenue and Taxation, telephone conversation, May 6, 1994.

16. 5 ME. REV. STAT. ANN. §1664.

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18. Addendum to Report of the Joint Standing Committee on Taxation Regarding Sales Tax Expenditures (Augusta: Maine Joint Standing Committee on Taxation, April 1993).

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20. Mark Haas, Director, Office of Research and Tax Analysis, Michigan Department of Treasury, telephone conversation, May 6, 1994.

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26. Dick Gebhart, Administrator, Division of Reseerch, Washington Depertment of Revenue, telephone conversetion, May 3, 1994.

27. Ibid.

28. Executive Budget: Tex Expenditure Appendix, p. 4.

CHAPTER FOUR

MONTANA TAX EXPENDITURES -- PART II

INTRODUCTION

Chapter Two of this report summarized the Montana Department of Revenue's (Department's) tax expenditure estimates contained in the tax expenditure reports for the 1990-91, 1992-93, and 1994-95 bienniums. The chapter presented tax expenditure estimates associated with the individual income tax, the corporation license tax, property taxes, and natural resource taxes. The purpose of the chapter was to provide a perspective on the kind of information presented in the tax expenditure reports and to indicate the historical trends in tax expenditure estimates and the relative magnitude associated with each tax expenditure.

The purpose of this chapter is to present the information contained in Chapter Two in a slightly different perspective. It shows tax expenditure impacts on revenue collections as well as general fund expenditures. In addition, the chapter highlights ways in which the review process of tax expenditures may be improved within the context of a tax expenditure report. This chapter focuses primarily on tax expenditures associated with the individual income tax, the corporation license tax, and property taxes. The chapter also suggests that tax expenditures associated with motor fuel taxes, alcoholic beverage taxes, and cigarette taxes should be included in the tax expenditure report. Appendix A contains the Department's response to suggestions articulated in this chapter.

MONTANA TAX EXPENDITURES REVISITED

Table 9, taken from Chapter Two, summarizes the estimated tax expenditures by type of tax for fiscal years 1990 through 1995. Table 10 shows the percentage distribution of tax expenditures by type of tax. The individual income tax has accounted for over 90% of all tax expenditures. Most tax expenditures in Montana (including most itemized deductions), both in number and amount of tax benefit, are passive in nature because Montana's individual

income tax law conforms with federal law. Excluding the deduction for federal income taxes paid (the single largest tax expenditure item in Montana), passive tax expenditures in fiscal year 1994 and fiscal year 1995 accounted for approximately 62% of all tax expenditures. The deduction for federal income taxes has generally accounted for about 23% of all tax expenditures. Montana-specific exclusions (e.g., exempt retirement income and the additional personal exemption for the elderly or blind) and Montana credits (e.g., the residential property tax credit for the elderly and the credit for income taxes paid to other states) account for roughly 10% of all tax expenditures.

Table 9: Summary of Estimated Tax Expenditures for All Taxes (Thousands of Dollars), FY90-FY95

	FY90	FY91	FY92	FY93	FY94	FY95
PERSONAL INCOME TAX						
Federal exclusions	$105,608	$116,805	$117,629	$126,127	$155,690	$166,095
Federal deductions	5,392	5,564	4,688	4,947	7,385	7,643
Montana exclusions	22,868	23,824	42,078	46,268	29,376	31,001
Montana deductions	130,433	137,372	159,948	167,200	168,526	171,986
Montana credits	6,279	6,492	10,677	11,049	8,715	8,915
Total	$270,580	$290,057	$335,020	$355,591	$369,692	$385,640
CORPORATION INCOME TAX						
Federal exclusions	$575	$653	$599	$630	$488	$531
Federal deductions	8,471	11,698	11,301	12,666	9,815	10,101
Montana credits	1,270	1,280	1,085	1,004	1,515	1,515
Total	$10,316	$13,631	$12,985	$14,300	$11,818	$12,147
NATURAL RESOURCE TAXES	$7,312	$4,456	$1,002	$1,116	$1,436	$1,450
PROPERTY TAXES	$9,730	$9,785	$3,854	$4,792	$3,076	$3,334
TOTAL	$297,938	$317,929	$352,861	$375,799	$386,022	$402,571

Source: Montana Department of Revenue, Tax Expenditure Report for the State of Montana, various years

Table 10: Summary of Estimated Tax Expenditures for All Taxes (Percentage Distribution), FY90-FY95

	FY90	FY91	FY92	FY93	FY94	FY95
PERSONAL INCOME TAX						
Federal exclusions	35.4%	36.7%	33.3%	33.6%	40.3%	41.3%
Federal deductions	1.8%	1.8%	1.3%	1.3%	1.9%	1.9%
Montana exclusions	7.7%	7.5%	11.9%	12.3%	7.6%	7.7%
Montana deductions	43.8%	43.2%	45.3%	44.5%	43.7%	42.7%
Montana credits	2.1%	2.0%	3.0%	2.9%	2.3%	2.2%
Total	90.8%	91.2%	94.9%	94.6%	95.8%	95.8%
CORPORATION INCOME TAX						
Federal exclusions	0.2%	0.2%	0.2%	0.2%	0.1%	0.1%
Federal deductions	2.8%	3.7%	3.2%	3.4%	2.5%	2.5%
Montana credits	0.4%	0.4%	0.3%	0.3%	0.4%	0.4%
Total	3.5%	4.3%	3.7%	3.8%	3.1%	3.0%
NATURAL RESOURCE TAXES	2.5%	1.4%	0.3%	0.3%	0.4%	0.4%
PROPERTY TAXES	3.3%	3.1%	1.1%	1.3%	0.8%	0.8%
TOTAL	100%	100%	100%	100%	100%	100%

Source: Montana Department of Revenue, Tax Expenditure Report for the State of Montana, various years

Based on the economic assumptions adopted by the Revenue Oversight Committee (Committee) prior to the 1993 Regular Session, individual income tax collections for fiscal year 1994 and for fiscal year 1995 were expected to be $330.249 million and $339.687 million, respectively. Estimated tax expenditures under the individual income tax were about 112% of anticipated individual income tax revenue for both years.

Most tax expenditures associated with the corporation license tax are also passive in nature. Corporation license tax expenditures have typically

accounted for less than 4% of all tax expenditures. Estimated corporation license tax expenditures were about 18% of anticipated corporation license tax revenue for fiscal year 1994 and fiscal year 1995. Natural resource tax expenditures and property tax expenditures are relatively insignificant. However, the property tax expenditures shown in Table 9 do not include estimates for most exempt property. Because most tax-exempt property (e.g., business inventories, certain agricultural products, the property of churches and certain nonprofit organizations, and government property) is not assessed, the Department is unable to accurately estimate tax expenditures for most tax-exempt property.

Total tax expenditures have been relatively large when compared to total anticipated revenue and current level expenditure estimates in both the general fund and the school equalization account. Total estimated tax expenditures for the 1995 biennium amounted to $788.6 million. Anticipated revenue in the general fund and school equalization account amounted to $1.74 billion, while estimated current level services amounted to $1.87 billion.* Based on these numbers, tax expenditures for the 1995 biennium are 45% of total revenue and 42% of total expenditures.

Because tax expenditures allocate state resources for selected programs, some states (e.g., Michigan) classify tax expenditures by budget function. This classification provides a consistent framework by which direct and indirect outlays may be compared.** A comparison of direct expenditures with tax expenditures in Montana is beyond the scope of this report. However, Table 11 shows the relative importance of tax expenditures by arbitrarily devised tax expenditure categories for fiscal year 1993.***

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* Anticipated revenue and current level services were obtained from Budget Analysis 1995 Biennium, vol. 1 (Helena: Office of the Legislative Fiscal Analyst, January 1, 1993).

** Executive Budget: Tax Expenditure Appendix (Lansing: Michigan Department of Management and Budget, February 1993), p. 18.

*** Fiscal year 1993 was used because House No. Bill 671 had not been suspended at the time Table 11 was constructed. Had House Bill No. 671 remained in effect, certain tax expenditure estimates for FY 1994 and FY 1995 would have been immaterial.

Table 11: Estimated Tax Expenditure Activity (Thousands of Dollars), FY93			
Retirement			
Pension contributions	$42,758		
Social security	15,393		
Life insurance	5,275		
Exempt retirement & interest	13,436		
Total		$76,862	21.5%
Homeownership			
Mortgage interest	$26,959		
Property taxes	8,248		
Capital gains	10,217		
Other	4,900		
Total		$50,324	14.1%
Health insurance & medical			
Health insurance	$28,676		
Medical	17,301		
Total		$45,977	12.8%
Investment & business assist.			
Accelerated depreciation	$10,317		
Investment credits	2,841		
Other	7,143		
Total		$20,301	5.7%
Agriculture		683	0.2%
Natural resource development		8,050	2.2%
Federal taxes		102,424	28.6%
Charitable contributions		11,537	3.2%
Other		41,742	11.7%
Total		$357,900	100.0%

Source: Derived from Tax Expenditure Report for State of Montana, Montana Department of Revenue, January 1991.

Note: The estimate in the tax expenditure report for exempt retirement income was reduced to account for the passage of Senate Bill No. 226. See Chapter Two.

As previously noted, the deduction allowed for federal income taxes paid is the single largest tax expenditure item. In fiscal year 1993, this deduction accounted for 28.6% of all estimated tax expenditures. Tax expenditures that

provide assistance for retirement and retirement planning (the $3,600 exemption of retirement income and the exclusion of pension contributions made during working years) is the next largest expenditure category at 21.5%. Tax expenditures associated with home ownership (14.1%) and with health and medical costs (12.8%) provided about the same level assistance for each category. Identifiable tax expenditures for business activity, agriculture, and natural resource development are relatively minor components of the total.

TAX EXPENDITURE REVIEW PROCESS

In Montana, tax expenditures represent a significant amount of foregone revenue. They also generally operate as off-budget entitlement programs that are not limited to a set dollar amount. However, unlike on-budget entitlement programs, tax expenditures do not undergo any kind of systematic review. There is no procedure to approve or disapprove the continuation of tax expenditures.

Tax expenditures do not necessarily represent good or bad policy. Many tax expenditures, such as the $3,600 retirement income exclusion and the deduction for home mortgage interest, are generally believed to serve legitimate goals. However, the purpose and effectiveness of these goals are rarely reviewed on a periodic basis. The balance of this chapter describes some ways in which the review process could be improved.

Individual Income Tax

As noted above, the individual income tax has accounted for most of the tax expenditures in Montana. In fiscal year 1994 and fiscal year 1995, federal exclusions and deductions accounted for over 40% of all tax expenditures. Because federal adjusted gross income is the starting point in determining the Montana income tax base, the Montana Legislature has only limited control over tax expenditures associated with federal adjusted gross income. Legislative tinkering with federal adjusted gross income would inevitably complicate the Montana tax return. The Montana Legislature intuitively recognized this problem during the 1993 Regular Session when it passed Senate Bill No. 235

(the sales tax bill) and House Bill No. 671 (the alternative revenue bill should the voters reject the sales tax referendum). Both bills would have eliminated itemized deductions and would have imposed a single rate on taxable income. As is the case under current law (pending the outcome of the popular vote on House Bill No. 671), both bills would have used federal adjusted gross income as the starting point for determining Montana taxable income.

The Legislature could exercise control over some federal exclusions and deductions from income. These could include, for example, the nontaxable portion of Social Security benefits or the higher deduction allowed for accelerated depreciation. Under the federal Revenue Reconciliation Act of 1993 (Pub. L. 103-66), up to 85% (previously 50%) of an individual's Social Security benefit may be included in gross income. The amount of taxable Social Security for Montana purposes could be increased or decreased, depending on how much tax relief the Legislature believes Social Security recipients should receive. With respect to accelerated depreciation, the Legislature could impose a mechanism to recapture all or a portion of the difference between accelerated depreciation and straight-line depreciation.

The Legislature does have significant control over Montana exclusions and deductions. Each Montana tax expenditure may be evaluated on the basis of whether it achieves its purpose at a reasonable cost and on the basis of whether there are unintended consequences.

For example, 15-30-111(2)(b), MCA, allows an interest exclusion of up $800 for a singe return and up to $1,600 for a joint return for taxpayers 65 years of age or older. The interest exclusion is not means-tested. Any taxpayer 65 years of age or older who has interest income is entitled to claim the exemption, regardless of the taxpayer's income. The exemption is worth more as marginal tax rates increase. In its tax expenditure report, the Department shows tax expenditures by income bracket for Montana-specific exclusions and deductions from income. For tax year 1993, the Department estimated that the interest exclusion amounted to about $2 million. Thirty percent of

taxpayers (i.e., taxpayers whose income exceeds $31,250) who claim the interest exemption received 50% of the benefit. The interest exclusion violates the principle of horizontal equity because there is favorable tax treatment based on the source of income (e.g., dividend income is not exempt). It also violates the principle of vertical equity because it favors high-income taxpayers over low-income taxpayers.

Retired taxpayers are entitled to exclude up to $3,600 of retirement income (15-30-111(2), MCA). The retirement exclusion is means-tested because it is reduced by $2 for every $1 of federal adjusted gross income in excess of $30,000. The retirement exclusion is generally a well-targeted tax benefit because it applies to most retirement income, regardless of source. About 83% of taxpayers (i.e., taxpayers whose income is less than $31,250) received 68.5% of the benefit. The provisions for the exclusion of retirement income encourage married taxpayers to file separately on the same return because the phaseout applies separately to each taxpayer's income. The ability to file separately favors, to a certain extent, high-income taxpayers over low-income taxpayers. However, there is a policy rationale for this. The Legislature wanted to ensure that Montana state and local government retirees would be able to exclude as much retirement income received from public service pensions as possible, even though private retirees and federal retirees would benefit equally.

A similar analysis may be performed for other exclusions and deductions from income and for income tax credits. The impact of income tax credits, however, is different from exclusions and deductions from income. A graduated tax rate structure makes exclusions and deductions more valuable to higher-income taxpayers. A credit based on a percentage of allowable expenditures provides more equal treatment across income levels because the amount of the subsidy for a given level of expenditure would be the same for all taxpayers, regardless of their income or marginal tax rate. The Department does not currently list the value of income tax credits by income class.

Corporation License Tax

Except for Montana-specific tax credits, most tax expenditures under the corporation license tax are passive in nature because Montana law conforms with federal law. Based on estimates contained in the Department's tax expenditure report, passive tax expenditures for the 1995 biennium account for a little over 87% of tax expenditures under the corporation license tax, while tax credits account for the rest.

Tax expenditures associated with the corporation license tax are understated because certain items, such as the "water's-edge" election and net operating loss provisions, are not included in the estimates.

In 1987, the Montana Legislature enacted House Bill No. 703 (Ch. 616, L. 1987) to allow multinational corporations to compute Montana taxable income on the basis of U.S. income only (water's-edge election), rather than on worldwide income. According to the Department, there are about 38 corporations in Montana that have made the water's-edge election. In May of 1992, the Department estimated the revenue loss associated with the water's-edge election to be $4.8 million over a 3-year period.

Corporations in Montana are allowed to carry back net operating losses to the previous 3 tax years and then to carry forward net operating losses to the next 5 tax years.* Corporations may elect to forego the entire carryback period so that losses are carried forward only (Ch. 538, L. 1989). The purpose of the deduction is to allow businesses to offset losses incurred in one tax year with income earned in another. Several states that prepare tax expenditure reports (e.g., Arizona and California) estimate foregone revenue associated with net operating losses. In Montana, most corporations elect to carry forward losses. This reduces the need to issue refund checks to corporations for prior tax years but may significantly reduce taxable income in the carryover period. The

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* Based on federal law, individual taxpayers in Montana may carry back losses to the 3 previous tax years and carry forward losses to the next 15 tax years.

Department is able to determine the tax impact of the deduction for net operating losses.

The credit allowed for the contractor's gross receipts tax (approximately $1 million for each year of the 1995 biennium) accounts for about two-thirds of the amount of tax credits claimed under the corporation license tax. The investment tax credit (limited to carryover amounts) and the Montana capital company credit were estimated to be a little over $400,000 for each year of the biennium. The total amount for six other credits (such as the new and expanded industry credit, the dependent care assistance credit, and the college contribution credit) was estimated at less than $100,000. Tabulating the number of corporations that take advantage of these credits would assist policymakers in analyzing the success of particular tax credits.

Property Taxes

Because exempt property is rarely appraised, the Department is able to provide tax expenditure estimates for only limited types of property. These estimates include reduced property tax rates for low-income residential property, the 12-month exemption of "new" oil and gas from net proceeds taxes, and the reduced property tax rate for new industrial property. The Department's tax expenditure report also lists the exemptions for business inventories and certain agricultural products but is unable to provide estimates. The list of property tax exemptions could be expanded to include mineral exemptions allowed under coal gross proceeds taxes and metal mines net proceeds taxes, the exemption for down-hole equipment in oil and gas wells, and the exemption for motion picture and television commercial property.

It would also be helpful to at least note in the tax expenditure report certain property (in addition to new industrial property) listed in 15-6-135, MCA, under class five property. This would include air and water pollution control equipment, real and personal property used in the production of gasohol, real and personal property of research and development firms, and machinery used in electrolytic reduction facilities (the aluminum plant in Columbia Falls). These

properties were included in class five to provide economic incentives (e.g., research and development property) or to provide economic relief (e.g., for the Columbia Falls aluminum plant). The tax rate for class five property is 3% of market value, which is lower than other classes of property.

Inclusion of Other Tax Expenditure Items

There are tax expenditures associated with the gasoline license tax and the special fuel use tax and with alcoholic beverage taxes and cigarette taxes that could be included in the tax expenditure report.

A person who pays directly or indirectly the gasoline license tax or the special fuel tax for off-road use or agricultural use may claim a refund or credit for taxes paid (15-70-221 and 15-70-328, MCA).

Title 15, chapter 70, part 5, provides that a producer of alcohol to be blended for gasohol is entitled to a tax incentive payment of 30 cents per gallon of alcohol produced. The maximum incentive payment for each producer is $3 million for any consecutive 12-month period. Beginning July 1, 1997, the maximum incentive payment allowed for a producer of alcohol is $1.5 million annually. The incentive payment ends July 1, 2001.

Title 16, chapter 1, part 4, MCA, provides that a distiller who sells more than 200,000 proof gallons of liquor nationwide is subject to a 16% liquor excise tax (and a liquor license tax of 10%) on the retail selling price on all liquor sold in the state. A distiller who sells not more than 200,000 proof gallons nationwide is subject to a 13.8% liquor excise tax (and a liquor license tax of 8.6%) on all liquor sold in the state. The purpose of the different tax rates is to provide a tax benefit to small, emerging distillers of alcohol.

A licensed wholesaler or licensed retailer of cigarettes is entitled to a percentage discount from the full face value of insignia attached to a carton of cigarettes (16-11-114, MCA). The purpose of the discount is to defray the

costs of affixing insignia and precollecting the cigarette tax on behalf of the state. Wholesalers of tobacco products other than cigarettes are entitled to a wholesaler's discount of 5% of the tax due for collection and administrative expenses associated with the collection of the tax.

CONCLUSIONS AND FINAL OBSERVATIONS

Tax expenditures represent a significant amount of foregone revenue, not only to the state but to local governments as well. Tax expenditures are also relatively large compared to direct expenditures. The tax expenditure reports prepared by the Department provide the basic information needed to evaluate the impact of most tax expenditures.

One issue is whether to expand the scope of information contained in the tax expenditure reports. This chapter (as well as other parts of the report) has suggested how that can be accomplished. For example, the tax expenditure report could be expanded to include additional information on taxes already listed in the report. This information might include tax expenditure estimates for net operating losses and tax expenditures associated with the water's-edge election by corporations. The report could also include tax expenditure estimates for other taxes, such as motor fuel taxes, alcoholic beverage taxes, and taxes on tobacco products. For the most part, the Department has indicated that these additions to the report are either too costly to implement or irrelevant. (See Appendix A.) On the other hand, Mick Robinson, Director of the Department, indicated to the Committee at its September 8, 1994, meeting that, given limited resources, the Department is striving to make both the biennial reports and the tax expenditure reports more meaningful documents. However, the Department's top priority is the biennial reports.*

In addition, each tax expenditure could be evaluated as to whether it has achieved its stated purpose or goal with few unintended consequences. It would be difficult (if not impossible) to develop empirical methods to objectively

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* Minutes of the September 8, 1994, meeting of the Revenue Oversight Committee (Helena: Montana Legislative Council), p. 16.

evaluate many tax expenditures. However, tax expenditures can be evaluated on the basis of the criteria of a good tax system.* This approach was briefly explored in this chapter in the analysis of tax benefits available to older taxpayers and in the discussion of other states' tax expenditure reports (Delaware in particular) in Chapter Three.

Another issue is whether it would be useful to establish a formal process for the systematic review and oversight of tax expenditures. This task could be undertaken during the interim by the Committee or by the Committee in conjunction with the Legislative Finance Committee. The process should also include full legislative review during regular sessions.

The procedures just described would require a substantial commitment of staff time and additional resources, as well as a substantial commitment of legislators' time and effort. The Revenue Oversight Committee decided not to make specific recommendations concerning tax expenditure reporting and review. Chapter Three discussed the reasons why state legislatures typically do not undertake this kind of systematic review of tax expenditures. Those reasons probably apply in Montana.

This report described the concept of tax expenditure reporting, reviewed the tax expenditure reports in Montana and other states, and suggested some ways to improve the reporting and review of tax expenditures. It is unfortunate that there is not general agreement about the concept of tax expenditure reporting and how tax expenditures fit within the budgetary and tax framework of the state. However, individual legislators and others may find the information in this report and in the Department's tax expenditure reports useful in their analysis of state fiscal policy.

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* See, for exemple, Jeff Martin, Chapter Two of An Overview of Taxation in Montana: Principles and Practice, A Report to the 53rd Legislature (Helena: Montana Legislative Council, November 1992), for a discussion of the criteria of a good tax system.

APPENDIX A

State of Montana

REVENUE OVERSIGHT COMMITTEE
SEPTEMBER 8, 1994
EXHIBIT #8

Department of Revenue
Mick Robinson, Director

ox 202701
9620-2701

August 31, 1994

TO: Jeff Martin
Legislative Council

FROM: Larry Finch, Program Manager
Office of Research and Information

SUBJECT: Response to the Legislative Council's Suggestions for Improvements to the Department's Tax Expenditure Report

Interim reports to the Revenue Oversight Committee provide useful suggestions for improving the Department's *Tax Expenditure Report*. This document provides a discussion of these suggestions, and the feasibility and necessity of implementing them.

Income Tax Credits, by Income Group

Council staff suggests that the *Tax Expenditure Report* should include tax expenditures for income tax credits, by income group, as is done with itemized deductions. The estimates of tax expenditures associated with itemized deductions by decile group are derived from the Department's five-year income tax simulator model. This model generally provides accurate estimates of itemized deduction amounts. However, the sample used for the model does not provide accurate estimates of credit amounts. It is likely that the sample would provide an even less accurate estimate of the distribution of credits across income groups. Consequently, the sample cannot be used to provide tax expenditures associated with credits by income group.

This information could be obtained in programs run against the entire population of returns each year. This would require additional programming on the part of either Operations Division staff, or Office of Research and Information staff. It also would require additional mainframe processing costs, and additional printing costs.

Corporation License Tax

Suggestions in the area of corporation license tax include adding tax expenditures associated with the "water's edge" election, and for net operating losses (NOLs) reported

by corporations. Although the Department has examined the revenue impact of the water's edge election in the past, annual revisions and updates of this expenditure would require extensive field auditing by staff every year. It's the Department's perspective that the costs of providing this information outweigh the benefit derived.

Determining the tax expenditure associated with NOLs is relatively straight forward. The data is available on the existing corp tax database allowing an estimate of the expenditure with relatively little additional resources required.

Council staff also notes that it would be worthwhile for the Department to list the number of corporations utilizing each of the corp tax credits available. This is already done in the Department's *Biennial Report* (see p. 38 of the most recent report).

Property Tax

The Legislative Council report suggests adding the following property tax expenditures:

1) mineral exemptions allowed under the coal gross proceeds tax;
2) mineral exemptions allowed under the metal mines gross proceeds tax;
3) the exemption for down-hole equipment in oil and gas wells; and
4) the exemption for motion picture and television commercial property.

One-half of the contract sales price of coal sold by a coal producer who extracts less than 50,000 tons of coal a year is exempt from taxation (MCA, 15-6-208(1)). The Department has information that allows the calculation of this tax expenditure, and can provide this information with very little additional allocation of resources. However, currently only one producer is producing less than 50,000 tons per year. Publishing tax expenditure data for this item would violate the Department's confidentiality rulings.

Metal mines producing less than 20,000 tons of ore a year are exempt from property taxation on one-half of the merchantable value. The Department's records for 1993 show five producers who are producing less than 20,000 tons of ore. The tax expenditure associated with these producers is less than $1,500. In past years the number of producers has been as low as one. The Department questions the value of including tax expenditures of this magnitude.

Many types of property are exempt from property taxation. Exempt property is not valued; therefore, it is not possible to estimate the tax expenditure associated with exempt property. This includes down-hole equipment and motion picture and television property.

Council staff also suggests that it would be useful to at least note other property, besides "new industrial property", in Class 5, which is taxed at a taxable valuation rate of 3 percent. The Department includes new industrial property in the tax expenditure report because of the specific preferential treatment afforded this type of property. That is, new industrial property is afforded a reduced taxable valuation rate for only the first three years of

operation. During this time it is being treated preferentially relative to other industrial property. After that it is taxed at the normal rates applied to all industrial property.

With the exception of certain property used in the production of gasohol, all other property in Class 5 receives *permanent* Class 5 status over the life of the property. For example, certain pollution control property is not treated differently from other pollution control property, consequently there is no tax expenditure associated with this type of property. (By the way, there currently is no gasohol property being taxed under the first three years' preferential treatment.)

The fact that Class 5 property is taxed at the lowest rate possible does not constitute a tax expenditure, regardless of the reason why property is included in that class. If that were true, then one could argue that property in Class 4 is treated preferentially because it is taxed at a lower taxable valuation rate than, say, Class 8 property.

Other Tax Expenditure Items

Finally, the interim report suggests that the Department include the following items in the *Tax Expenditure Report*:

1) the credit provided for gasoline tax paid for gasoline used to denature alcohol to be used in gasohol, for operating stationary gasoline engines or tractors used off the public highways and streets, or for any commercial use other than propelling vehicles on a public highway or street (MCA, 15-70-221);

2) the credit provided for special fuels tax paid for any use off the public roads and highways of the state (MCA, 15-70-328);

3) the $0.30 credit per gallon tax incentive associated with the production of alcohol produced in Montana from Montana products, and subsequently blended with gasoline for sale as gasohol (MCA, 15-70-522);

4) the discounts provided in MCA, 16-11-114 and 16-11-206 for defrayment of the costs incurred by licensed wholesalers and retailers of cigarettes and other tobacco products for affixing insignia and precollecting tobacco products taxes for the state.

The Department of Revenue no longer administers the taxes associated with the first three items listed above. The information would have to be obtained from the Department of Transportation. While it is possible to do this, it would require additional time on the part of personnel in both Departments to coordinate and report these expenditures.

The discounts provided in 4, above, for defrayment of administrative costs are not considered by the Department to be tax expenditures. They do not provide for differential or preferential *tax* treatment of one class of taxpayer over another, but simply represent a reimbursement for the administrative costs associated with the collection of taxes.

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